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PRESIDENT REAGAN'S ECONOMIC PROGRAM

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MONDAY, MARCH 30, 1981

PRESIDENT REAGAN'S ECONOMIC PROGRAM

MONDAY, MARCH 30, 1981

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 6226, Dirksen Senate Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Richmond.

Also present: James K. Galbraith, executive director; Richard F. Kaufman, assistant director-general counsel; Charles H. Bradford, assistant director; and William R. Buechner, Mark R. Policinski, Douglas N. Ross, and Robert E. Weintraub, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning.

The Joint Economic Committee will be in order for its continued exploration of how we may emerge from the present economic muddle.

The Joint Economic Committee Democrats, in their annual report earlier this month, said—and I'm quoting from the introduction on pages 4 and 5 of the report—"The Administration's program for economic recovery deserves prompt, thorough, and fair-minded consideration by the Congress. Much of it—such as the call for liberalized depreciation, for regulatory reform, for budgetary control—is exemplary. But there are important differences between the Administration's program and our own."

One—and here I summarize—the administration believes that the Federal Reserve should tighten its monetary targets over what they are now. While we oppose such action, interest rates are too high and will remain too high if the Federal Reserve continues to tighten its monetary targets. Even though control over inflation has not been achieved, excessively high interest rates will retard investment growth and control over Federal expenditure.

Two, the destructive fiscal facet of the administration's program is the proposed huge individual income tax cut, amounting to more than $140 billion per year when fully effected. When the budget and inflation are brought under control, the benefits then should be promptly distributed to the taxpayer in a fair and equitable way.

Three, the administration's program in our view does not sufficiently recognize the structural nature of our problem of investment and crisis. Investment programs—including employment training, economic development, infrastructure research and development—are repealed or drastically slashed. On the price side, there is nothing at all. The administration utterly rejects any policy to stabilize prices and wages.

So there is a difference, we continue, between the administration's views and those presented by the Joint Economic Committee Democrats. We view these differences not as a stalemate, but as an opportunity for reconciliation.

The administration says the budget must be cut; so do we. The administration says that the growth of money and credit must be controlled; so do we. But we recommend specific action for bringing interest rates down.

The administration wants a vast personal income tax cut, mostly effective in the future; and we are told that for some reason it must be enacted now. We favor more modest tax cuts, less oriented toward the affluent, more oriented toward the supply side.

These are not irreconcilable differences. We approach the administration in a spirit of compromise, and we look forward to working together toward a common ground. So we said earlier this month. Since then, as one knows from reading the press, our olive branch has not exactly been nuzzled to the administration's bosom. But I hope that the Rostenkowskis, the Jones, and the others in the House will continue their efforts.

We are fortunate to have before us one of the outstanding financial men of the country and, in his day, one of the most able public servants. Peter Peterson was Secretary of Commerce and held other high posts in the Republican administrations of the early seventies. And he is now chairman of the board of Lehman Bros., Kuhn, Loeb, Inc.

Because he is always a thoughtful contributor to the economic dialog, we have asked him to come here this morning and give us some guidance and advice on where we should go.

Thank you very much, Mr. Peterson.

We have your very compendious prepared statement, with attachments, which under the rule will be received in full.

And now, would you proceed in any way that is comfortable to you.

STATEMENT OF PETER G. PETERSON, CHAIRMAN OF THE BOARD, LEHMAN BROS., KUHN, LOEB, INC., NEW YORK, N.Y.

Mr. PETERSON. Thank you, Mr. Chairman.

First of all, I want to congratulate the committee. You have made the consensus, I believe, around productivity, investment, research and development and the fact that these deserve top priority makes this a landmark event in the country. And I congratulate all of you for doing that.

Second, let me define what I think I am and what I know I am not. I know I am neither an economist nor a politician. I think I am a very interested and concerned observer of the rapidly declining position of the United States in the world economy.

A few of you here suffered through my slide presentation in 1971, where, as Assistant to the President for International Economic

Affairs, I presented a study on the United States in the changing world economy.

For the last year or more, Mr. Chairman, I have been updating that study. And with your kind permission, I have included a speech that includes many of the charts from that study.

The good news is that I'm not going to show you those 128 charts today. And the bad news, I'm afraid, is what is on the charts themselves.

It has become politically popular to make dark, morose, doomsday projections about our economy. Indeed, there is much to be morose about.

Still, my basic conclusions from all of this study are essentially optimistic, with one very big "if"—if we really learn and apply the lessons that those gloomy trends and our preformance in the world economy suggests. Now, if we don't, and we continue the recent trends, where our productivity declines—as Japan's, for example, has been moving steadily up—we face a decade—indeed decades of very real danger, where the United States has neither the resources nor the credibility to make its indispensable contributions, not only to the improved standard of living of our citizens, but what we have come to call the free world.

Now, why am I optimistic? Really for two reasons.

First, we do have the example of Japan, with vastly fewer resources, much less energy, much less food, many fewer minerals which has done vastly better than we in every key economic respect, productivity gains, unemployment, inflation, interest rates, strength of its currency, and the ultimate bottom line, growth in the real income of its people; while we have stumbled into zero growth that we used to only idly speculate about.

The second reason I am optimistic is the political miracle that I believe President Reagan deserves an awful lot of credit for, a miracle that has resulted in a consensus that contains the indispensable ingredient for getting us out of the economic mess that we—and I use that, Mr. Chairman, "we" in the bipartisan sense—have gotten ourselves into over the last two decades.

This consensus on the economic front makes inflation public enemy No. 1. It makes Government spending, Government deficits, and Government borrowing and ballooning regulation and money supplies principal culprits. It makes productivity much more than the yawning political MEGO. You recall that aphorism Mr. Chairman, "my-eyes-glaze-over subject".

And my being here is an attempt to suggest that we consider a few ways that our country might achieve the fullest potential from the President's remarkable political achievement. Permit me to suggest two basic ways of thinking about the President's program, the basic thrust of which I strongly support.

First, may I suggest, Mr. Chairman, that, in thinking about this program, it is important that all of us take the long-term view. It took us at least two decades to get into this mess. I hope it doesn't take us that long to get out of it. It needn't, but it will certainly take quite a number of years.

Now, on the budget side, for example, for at least two decades we have seen ever-rising rates of government spending. And let's be sure, therefore, that we set into place processes and concepts of budget reductions which are sustainable and equitable, not just in 1981 and 1982, where the President's efforts are valiant, but in 1983, 1984, 1985, 1986, and so forth.

Second, another guideline I suggest to you is the need to generate at least an additional 3 percent of GNP, and I think closer to 5 percent, in productivity-enhancing investment, in plant equipment and very important research and development and innovation.

On this key second issue, I remind you of Japan's experience, which is documented in the papers that I have left with you. It is extraordinarily relevant and, I think, encouraging. Japan, with an economy half the size of ours, is now spending more in absolute terms than we are in plant and equipment. As a result, their equipment is now half the age of ours, and I think the American people are beginning to understand that. I think the American people know that Japan is also doing better on investment in R. & D. investment and human capital.

For the last 15 years, for example, they have doubled their output of scientists and engineers, while ours has gone down 5 to 10 percent. I think the American people also know, in R. & D., that Japan's is increasing and ours is decreasing. On patents—and in the study material that I left with you, I remind you that between 1968 and 1978, the number of U.S. patents declined 10 percent, while Japan's increased 372 percent.

Starting in 1975, the patent analog of the trade balance, the patent balance, shifted in Japan's favor.

In my government days, so-called technology-intensive products were the litmus test of U.S. economic superiority. Japan now has the largest surplus, in absolute terms, of any country in the world, again with an economy half the size of ours.

On trade, we permitted ourselves, Mr. Chairman, to say that oil imports, and OPEC and so forth present an almost hopeless situation, as though we have a patent on the problem.

In the material I have presented to you, and in my prepared statement I therefore took Japan's trade experience between 1970 and 1979. You will see, and I'm sure you know, that they have absorbed much heavier burdens than we, not just much more oil, relatively speaking, but a $13 billion larger food deficit and $15 billion larger resources deficit than in 1970.

Yet, how have they fared so much better than we on the trade account? By an absolutely remarkable improvement in their manufactured goods surplus, by an astonishing $62 billion, spurred by investment, spurred by R. & D., spurred by productivity.

Part of their success is what I guess we would call micro these days, Mr. Chairman, managerial if you will. And in my judgment American management and American labor face the profoundest management challenge in their history, but that is not the subject of these hearings.

There are, also, some very important macro incentives—a part of the study I referred to—and is included in some of the material I have left with you—is a study of the differences in the savings and investment tax incentives of our country versus Japan, Germany, and Britain and some other countries. I don't need to repeat what is in my statement, and it is better understood by looking at the tables in that statement.

But generally speaking, the United States is the low man—I guess these days I should say low person on the totem pole. Our taxes on investment, capital gains, property, corporate taxes are generally the highest in any industrialized country in the world. Most of these countries wouldn't hear taxing unearned income in a discriminatory way. Most have much lower capital gains taxes, if any at all; and most of them have generous personal deductions for ordinary interest or dividend income.

I have neither the expertise nor the staff to examine how the President's tax cut is likely to increase investment in plant equipment and R. & D. But I have suggested that Congress, cooperating with the administration, might want to ask a bipartisan group, such as the Committee to Stop Inflation, chaired I believe by Arthur Burns and Joe Fowler, to assess whether and to what extent the program is likely to achieve the increases in investment and in research and development that our dismal record and Japan's brilliant records strongly suggest that we need.

Now, a few words about the budget reductions, which are absolutely indispensable, from where I sit should be even higher than they are, to minimize not only the deficits, but their first cousin, which from the vantage point of Wall Street at least leads to another very important source of inflation, the unprecedented level of government borrowing that is now taking nearly one-quarter of the total credit borrowing in the United States.

My focus on the budget cuts, Mr. Chairman, is again, as in the investment area and productivity area, not simply 1981 and 1982, but 1984, 1985, 1986, and the rest of the decade. Frankly, Mr. Chairman, I have not been able to see how we are going to get the indispensable budget reductions long term—and I underline long term—that we obviously need unless we also include the so-called indexed entitlement programs, the safety-net programs that are expected to grow to 40 percent of the total budget by 1984. If we exempt these and if we meet our defense-increase targets and if we exempt interests costs, about which there is not really a great deal that one can do, at least in the sense of accruage prediction, elementary arithmetic tells us that we must get more and more of these very large reductions from less and less of the budget, less than 30 percent; which, if our calculations are right, would suggest that this all other category would need to be cut fully by half by 1985.

A few of these cuts, for example, Mr. Chairman, are in the area of basic research and science education and are related to the long-term productivity issue that is the subject of these hearings. Beyond the simple pragmatic question of being able this way to get the needed budget cuts, long term, that I keep emphasizing, my statement really raises two other questions.

First, the criterion of equity—I would would like to give you two examples. The 100-percent social security indexing program that we have last year went up 14.3 percent. I needn't remind you that it was tax free. I am told that the actual cost of living of our senior citizens went up 8 to 9 percent. This suggests that the real after-tax-income gain on the part of those recipients was roughly 5 to 6 percent. At the same time this was happening, the workers of this country got a pretax increase of perhaps 9 percent, perhaps after-tax, not the 14.3 percent that the social security recipients got, but probably 6 to 7 percent. Their cost of living, however, really did go up 14 percent. So they suffered real decline in after-tax real income.

Let's also look at Federal pensions, which I imagine is also a rather tender subject. Again, it is indexed 100 percent. I asked myself the questions, Mr. Chairman, how does this compare to the pensions of other workers in America who, after all, are contributing the taxes to pay for these pensions?

If you have not done so, I urge you to study the pensions of America's nongovernment workers. According to my informal checks, very, very few get formal indexing at all. Most of them get, if they get any, ad hoc and partial indexing. And where they do, it is certainly less than 100 percent.

By 1984, I am told, if we were to go, let's say, to an 85-percent inflation rate, this would save us something like $11 billion, an astonishing number.

Frankly, I have to also raise the question as to whether this 100-percent indexing scheme is really, at the time we are talking about the sharing of sacrifice, a highly rigorous fairness test, whether it really meets another criterion that we have rightly talked about.

We have talked a great deal, Mr. Chairman, about meeting the needs of the truly needy. Therefore, against that standard, I have taken the two largest 100-percent indexed entitlement programs, social security and medicare. I've asked what percentage of the recipients of those programs are at the poverty line or below. My indications are that something like 80 percent of the people who receive those two programs have incomes above the poverty line.

So, on a test of the criterion of either equity or meeting the needs of the truly needy, it is not at least obvious to me how leaving those programs intact meets those two tests.

Speaking of indexing, Mr. Chairman, I have just returned recently—which may explain my unusually sleepy condition—from a visit in Israel, where I met with a number of the top government officials, including the head of their central bank. It was interesting to me to see that country, with its absolutely staggering defense burden, a burden, as you know, that is several times ours, the difference in emphasis in its programs on indexing.

They, too, as you know, have an important commitment to social programs. However, their indexing, as it was explained to me, is significantly less than 100 percent on those programs. But their commitment to savings and investment is apparently even stronger, because their savings programs are indexed 100 percent, plus a real rate of return of 5 to 6 percent to the saver.

My prepared statement, Mr. Chairman, finally demonstrates my nonpolitical, nonpolitician credentials by recalling an advertisement of earlier years—as I recall how it went, "If eventually, why not now?"

Will it really be politically easier, I wonder, for the Congress to face these indexed entitlement programs in the 1982 election year, and when some of this remarkable political consensus that we have now may have faded?

Besides, I would like to see next year's political energies focused on two absolutely essential programs, very unpopular questions to even raise, that none of us really wants to talk about.

First, a fundamental restructuring of our virtually bankrupt social security system and a serious consideration for private retirement and savings alternatives.

And second, reducing our frightened vulnerability to oil imports in the 1980's which if we don't find the political courage to do something important about it, could send any economic plan, however perfect, its mix of budget cuts and tax incentives, into a genuine tailspin.

I end my statement—and hopefully I haven't overdone it—by saying that the decades of the 1980's is indeed a kind of historic, if not ultimate, battle, a kind of economic and political Armageddon. However, it is not a choice between good and evil. It is a choice, rather, between spending much less in the present and investing much more in the future versus our reverse and disastrous choice the last two decades.

And I end by asking: Is there really a choice?

Thank you, Mr. Chairman.

[The prepared statement of Mr. Peterson, together with the attachments referred to, follows:]

PREPARED STATEMENT OF PETER G. PETERSON

It is an honor to be asked to address this distinguished committee today. I admire the leading role that the JEC has taken in forging a bipartisan consensus in support of the long-range policies needed to rebuild our nation's economy. Your focus on investment, capital formation, R&D, and productivity is well placed, and your courage to depart from conventional political and economic wisdom is widely appreciated. Without your past efforts, the intellectual consensus we see emerging this year would not be so well-focused or so compelling. I shall say more later about my deep admiration for President Reagan's remarkable contribution.

I speak today neither as an economist nor as a politician. If my perspective is at all unique, it is as an active and interested student of the relative economic performance of our nation within the international economy. A few of you may remember that in 1971, as the President's Assistant for International Affairs, I directed a study entitled "The United States in the Changing World Economy". Nearly ten years later, I have now updated that study and, candidly, have been appalled at how poorly we have done compared to two of our leading competitors, Japan and West Germany: countries with far more serious energy and resource problems than our own.

Much has been said about the "window of opportunity" that the Soviet Union will have between now and 1985 due to our unwillingness to meet our defense needs in the past ten years. I am profounly sympathetic with the need to redress this disparity and am pleased that President Reagan has moved to do so. But I am, if anything, even more concerned about the potential danger that we face if we experience another decade of woeful economic performance. Project, if you dare, ten more years of declining U.S. economic performance versus the economic and technological advances of Japan and our competitors. Such a projection produces more than a temporary "window of opportunity": it results in a decade of real danger—a period of national and international insecurity in which the U.S. has neither the resources nor the credibility to do the lonely job of world leadership that is our unique responsibility.

Thus, I feel it is much more than an intellectual exercise to study and apply the economic lessons of our ablest competitiors. As time is short, I shall discuss only Japan. There are real lessons to be learned, and it is these lessons which should concern us today. Some of these lessons are at the micro and managerial level and while this is not the subject of these hearings, I believe American management and labor face their most profound crisis ever, whatever you and the

President decide to do about his program. But there are also real lessons on the national or macro-level, and it is these we are concerned about here. With the Chairman's permission, I shall enclose a speech that includes a number of charts from my updated study that hopefully illuminates the melancholy trends.

Today, the American people see the connection between the Japanese auto worker who saves up to 25 percent of his earnings, the unparalleled levels of automation in Japanese manufacturing, and the fact that Toyotas are multiplying not on the docks of Tokyo, but on the streets of America. Japan, with an economy half the size of ours, began in 1980 to spend more in absolute terms on plant and equipment than the U.S. Its plant and equipment is approximately half the age of ours.

Today, the American people understand that our stagnating investment in a special kind of human capital, technological training and education of our people, has cost our economy untold numbers of jobs. In the last fifteen years, Japan and West Germany have more than doubled their output of scientists and engineers. We are educating 5–10 percent fewer scientists today while, interestingly enough, the number of lawyers educated in the 1970's has grown by 83 percent.

Today, the American people understand that we cannot have growth in our real standard of living unless we invest more in research and development. While the number of patents issued to U.S. companies declined by approximately 10 percent between 1968 and 1978, the number of patents issued to Japanese concerns increased by 372 percent, especially in high-technology fields. Since 1975, the number of U.S. patents issued to Japanese firms has exceeded the number of Japanese patents issued to U.S. businesses. One would expect a higher rate of growth from the Japanese, given our large base, but why should our patents decline in absolute terms? For technology-intensive products, in which America has typically been the world leader, Japan last year had the largest absolute trade surplus of any country in the world. This stronger performance unquestionably is linked to Japan's focus on investment.

Finally, the American people recognize the historical role played by small entrepreneurial companies in our nation's growth, such as Xerox, Polaroid, Texas Instruments, Hewlett Packard and others. Technologically-based small companies account for 50 percent to 70 percent of our commercial innovations and greatly contribute to our nation's growth in employment. And yet, while in 1970, 548 small companies came to the public market for funds, in 1978, there were only 29. The data for 1980 and 1981, due to reductions in the capital gains tax, appear to be more favorable. Still, these days one has to squint hard to see the emerging Xeroxes, Texas Instruments and Hewlett Packards of the eighties. It is a matter requiring urgent attention.

For too long, America's political leaders have left the American people with the melancholy feeling that we are facing a "hopeless" situation, with all of our problems caused by our oil imports and OPEC. I was struck by the obvious fact that between 1970 and 1979, Japan did vastly better than we. And as I recall, they import a "little" bit of oil themselves. So I thought it would be interesting to take 1970 and 1979 and look at how the Japanese did it. Sure enough, their fuel (chiefly oil) deficit went up an extraordinary amount in relation to their GNP—some $41 billion in that period of time versus $56 billion in the United States with a much larger economy. However, in addition, Japan had a food deficit that was roughly $13 billion higher than it was in 1970, and of course that's the area where our country has shown remarkable surpluses. Japan also had a $15 billion increase in their resource deficit during that nine year period. Now if you aggregate these, you will see that Japan absorbed an extraordinary $69 billion of increased deficits in 1979 than they had in 1970 from fuel, food, and resources.

How did they do it? The answer is clear: spurred by investment-led productivity increases, their manufactured goods surplus went from almost $14 billion in 1970 to an astounding $76 billion in 1979. There are roughly 40 to 50,000 jobs per billion export dollars as well as other anti-inflationary implications. Think of how that improvement of some $62 billion would affect both unemployment and exchange rates, as well as the federal deficit.

What has been the bottom line—the payoff of all these investments to enhance productivity? Japan has enjoyed less than half the rate of inflation and rates of interest, a much stronger currency, much lower rates of unemployment, and the real payoff—real growth in the income of the Japanese people, compared to the zero growth we have stumbled into.

During the past several months, President Reagan has focused the attention of our nation on these critical economic realities. He has forged a remarkable political consensus that is a stunning departure from the fragmented views of the American people in the past, and the most sweeping reversal in the direction of national economic policy since the New Deal. Who could imagine having a serious debate—"pre-Reagan"—whether the budget cuts should be $45 billion or $40 billion, or indeed whether the budget should be cut at all? Who could conceive that we as a nation would seriously rethink the efficacy of the regulations that have tied our economy in knots. Who could dream—"pre-Reagan"—that we would be seriously debating which large tax incentives will most effectively spur business investment.

For this indispensable contribution, the President deserves our deep respect and admiration.

In my mind, the philosophical consensus forged by President Reagan is much like a tender tree sapling. It is young, fragile and must be supported by all us if is to survive. Yet, like a sapling, there are opportunities for careful pruning and shaping to allow the program to reach its full potential. As in the case of a tree, we must be careful not to alter so many factors that the health of the whole program is jeopardized. It is a fine line that must be walked carefully.

The comments that I make today are consistent with this view. I strongly support the outlines of the Reagan program—more investment, slower growth in Federal spending, less regulation and a stable monetary policy. Yet, I also feel that there are a couple of areas where we should consider whether President Reagan's program achieves the fullest long-term potential of his brilliant political achievement.

In my view, the Reagan program should be judged primarily on two bases. First, the focus of the program must be long-term. It took years to get into this mess and it will certainly take the better part of the next decade to get out. With respect to the budget, for example, it has taken two decades for the pressures of ever greater government spending to develop. President Reagan has made a valiant effort to cut the Federal budget in 1981 and 1982 and to reverse this trend. He deserves to be strongly commended for this effort. However, we should not and cannot expect one or two years of vigorous budget cutting to solve the long-term problem that we face. Instead, we need a policy that produces sustainable, consistent, equitable and large budget savings, not just in 1981, 1982 and 1983, but throughout the remainder of this decade.

Second, and in my view even more important, we must focus on the need to generate at least 3 percent, and I believe closer to 5 percent, of GNP per year in productivity-enhancing investments. To me, the long-term and absolutely central question is where to find this 3-5 percent of GNP to invest in plant and equipment and, equally important, in research and development? It seems to me obvious that the remarkable Reagan consensus I referred to earlier says that much of this must come from the share of GNP traditionally taken by government spending.

In sum, I am concerned, first, that the budget cuts now before the Congress may not be sufficiently long-term in their perspective and second, that the tax program may not generate the investment that is so essential to our economic recovery in the next decade.

First, let me briefly discuss the Reagan tax program. Over the five years of the program's effect, 78 percent of the revenue lost goes to personal tax cuts and only 22 percent to corporations to spur investment, and there is little, if anything, especially targeted to stimulate R&D, technological innovation, etc. My clear impression is that priorities may be somewhat askew. As important as personal tax cuts are, and I agree that over time we must reduce the tax burden on our citizens, my comparative studies of our lamentable international competitive performance lead me to believe personal tax cuts should take a back seat to a more investment-oriented tax program.

The tables I attach to this statement, which show a comparison of U.S. tax policies with those of our major economic competitors, are very revealing on this point. We find that the U.S., compared with four of our largest competitors—Japan, West Germany, France, and the United Kingdom—presently extracts the greatest share of its public revenue from progressive taxes on income, investment, and property, and the smallest share from proportional taxes on payrolls and consumption. We also find that U.S. public revenue received from taxes on investment, capital gains, property, and corporate earnings presently exceeds, as a share of GNP, that of any of the other four. Should it really surprise us that our levels of household savings and of business capital formation are, as a share of GNP, the lowest—often by far the lowest? If we want to reverse this sad trend, we should look at these countries for some positive alternatives.

Three of these four countries would never hear of taxing "unearned income." Only the U.K. shares this punitive tax with us.

All of the four—especially Japan—grant generous personal deductions for ordinary interest and/or dividend income. France has recently instituted a comprehensive deduction for new or rolled-over investments. Our $200 per year income deduction is pathetically small and is not a permanent tax-law provision.

All of the four have a more or less integrated corporate tax, whereby investors receive a personal credit on dividend income to compensate for the corporate tax already paid. Not only does this reduce the overall tax on investment income, it also mitigates the "lock-in effect" and frees capital to smaller, newer enterprises. The U.S. alone has no such provision.

All of these four have a less punitive capital gains tax. Germany has no long-term securities gains tax. Japan has no ordinary securities gains tax at all. In our unindexed system an investor can be taxed even for a long-term loss.

Finally, notwithstanding these personal allowances, the most recent studies indicate that our corporate tax is at least as high as in the other four countries. Assuming full distribution of earnings, ours is the highest.

I have neither the expertise nor staff to examine how much President Reagan's tax cut is likely to increase investment in plant, equipment, and R&D. I have suggested elsewhere that the Congress might be well advised to convene a bipartisan group of acknowledged experts—such as the Committee to Stop Inflation, chaired by Arthur Burns and Joe Fowler—to assess whether this tax program is likely to achieve the increases in investment that I believe our dismal record—and Japan's brilliant record—strongly suggest we need.

With respect to the President's budget proposals, I am concerned that they may not provide a sufficient basis for a long-term, sustained, consistent and equitable reduction in the rate of growth in Federal spending. All of us recognize that it is not enough simply to reduce the role of growth of Federal spending in the next couple of years. Instead, we need a consistent and long-range effort to free up our nation's capital to finance the private sector plant, equipment, and research and development and that we so desperately need. I frankly am worried that the President's budget proposals may not free up the resources that we need in the coming decade. I say this not simply to imply that we need larger budget cuts in 1982, which I do, but rather to suggest that the focus of the budget cuts should be changed somewhat.

I think it is virtually axiomatic that, in the next decade, the major government programs—other than defense—must grow at a rate significantly less than the growth rate of GNP. This suggests that all domestic programs must share in the spending reductions if we hope to reduce the rate of growth in Federal spending in a significant, equitable and consistent way. President Reagan has exempted a substantial part of the budget—most of the indexed entitlement programs—from this careful scrutiny. This decision, in my view, will make it difficult for us to achieve our budget goals in the coming decade.

The indexed transfer programs are by far the largest and fastest growing part of the Federal budget, increasing 61 percent faster than GNP since 1965. In fiscal year 1981, for example, the directly indexed transfer programs account for more than 30 percent of all federal spending, and the indirectly indexed programs account for an additional 10 percent. In the 1970 budget, by contrast, only 3 percent of the total budget was indexed.

Of the indexed programs, the President has proposed some cuts in the Medicaid, food stamp and child nutrition programs, but the so-called "safety net" programs—37 percent of all spending in 1981 and expected to climb to almost 40 percent of spending in 1984—have remained intact. When we consider that defense spending currently accounts for 25 percent of the budget and interest payments on the federal debt for almost 10 percent, it quickly becomes apparent that the vast majority of the budget cuts will come from less than 39 percent of the budget.

While this is a significant enough problem in fiscal year 1982, it becomes extraordinarily difficult in future years. President Reagan expects to increase real defense spending by more than 8 percent per year. Were the "safety-net" programs and interest on the bebt to maintain projected growth rates, then the remaining 30 percent must be cut by 10 percent per year in real terms simply to keep federal spending in pace with inflation. The President's goal, of course, is to keep federal spending growth substantially below the rate of inflation. This would require that this 30 percent of the budget be cut fully in half by fiscal year 1985. Small wonder, given the exclusion of the "safety net" programs, that it is necessary to slash highly sensitive programs by draconian percentages.

So well has OMB already plundered this corner of the budget that the remainder either has been deeply cut already (such as state and local grants), is extremely popular (such as national parks) or is absolutely essential (such as the FBI and CIA). Over a longer period of time—and that is the focus of my comments today—the President will be in the position of climbing an ever steeper hill of ever-decreasing budget savings at ever-increasing political costs.

I am concerned about this approach in two respects. First, from the standpoint of increased productivity, the exemption of the "safety net" programs has caused excessively deep cuts in some programs that can contribute to enhanced productivity in the coming decade. Basic research, science education and numerous capital investment programs have been cut more deeeply than would be necessary if all of the budget was scrutinized carefully. In the investment-oriented economic program which I favor, I am uncertain of the logic of maintaining intact a large number of transfer programs, but cutting many of the more investment-oriented programs quite deeply.

Second, all of us must worry about the long-term viability of any economic program that asks for sacrifice, but does not appear to distribute the burden equitably among all elements of our society. You know much better than I the political problems created by such an approach, so I need not elaborate.

For these reasons, I believe that we should seriously reconsider the current "do not touch" policy toward the entitlement programs and their indexed increases. In suggesting this approach, it is interesting to recall that indexation was originally created to protect the budget against excessive generosity toward the beneficiaries of these programs. Yet, in this case, the cure may have been worse than the disease, for we are now over-compensating these very same citizens.

Most economists seem to agree that the Consumer Price Index, the legal basis of indexing, has generally risen at a pace exceeding the true increase in the cost of living and, in particular, the cost of living of senior citizens. Certainly, last summer's 14.3 percent tax-free increase for social security retirees far outpaced the increase in wages of the average worker, which went up only 9 percent pre-tax. This summer's adjustment of about 12 percent continues to exceed current wage gains. In my judgment, the simplest principle of equity suggests that the increase in income to those receiving social security benefits should not be higher than to those paying for the benefits. One possible solution is to limit the inflation adjustment in Federal programs to the increase in the CPI or the growth rate in hourly earnings, whichever is lower.

There is no question that minor indexing revisions can yield enormous budget savings. Let us assume, for example, that the beneficiaries of the directly indexed entitlements receive an inflation adjustment of 85 percent of the CPI, rather than the full CPI. If only the current $190 billion in formally-indexed federal entitlements is considered, over $3 billion would be saved in fiscal year 1982. By 1984, assuming an ongoing 10 percent inflation rate, Federal outlays would be $11 billion lower than projected, and the cumulative savings to the taxpayers over the three years would exceed $20 billion.

This line of budget thinking could extend, in my view, to Medicare, veterans benefits, and federal employee pension plans. I might add, with regard to the Federal pension plans, that I have asked each of the companies on whose boards I serve, whether they have 100 percent fully indexed pension plans for their employees. Not a single company has such a program. They typically are ad-hoc or partially indexed at best.

While there are sound reasons to scrutinize the indexed entitlement programs, we must also be careful to provide an adequate level of income to the truly needy in our society, a point that the President has appropriately emphasized in his statements. For example, we could consider full indexation for the beneficiaries of these programs who have incomes below the poverty line.

At the same time, however, we should not delude ourselves about who benefits from these indexed entitlement programs. To take two of the largest programs—Social Security and Medicare—as examples, more than 80 percent of the beneficiaries of both of these programs have incomes above the poverty line. So we should not deceive ourselves into believing that by making these programs exempt from budget cuts, we are simply protecting the truly needy in our society.

While on the subject of indexing, I have just returned from a visit to Israel where I visited with a number of their leaders. They talk about their "indexation wonderland". To show you what they are learning from their painful, indeed brutal experience—heavily influenced of course by a defense budget several times ours—they now have less than 100 percent indexing in their social benefit programs; by contrast, they have 100 percent indexing plus a real rate of return on their savings plans, which has certainly stimulated much higher levels of savings and investment.

Taking the longer view, which I believe our circumstances require us to do, it seems to me inevitable that the huge indexed, transfer payments programs must at some point become part of any major, sustained, and equitable budget reduction program in the eighties. Speaking of inevitability, I am reminded of a television commercial some years ago that put forth the rather insistent question, "If eventually, why not now?" Indeed, I ask myself, why not now? Of course, there are political costs with particular constituencies, but in terms of the public as a whole, have we, thanks largely to this President, other than in wartime ever been more unified to get to the roots of our bloated and out-of-control government spending? Would you, for example, really rather wait until you are closer to the 1982 Congressional elections before taking on the millions of voters—whether they are truly needy or not—who receive the benefits of these indexed, transfer payments programs?

Even as a non-politician, I can appreciate that real time, and indeed enormous effort, will be required to build a political consensus for two other absolutely crucial items on the national agenda: First, a fundamental restructuring of our virtually bankrupt Social Security system which would include, I hope, some equally fundamental rethinking of private sector retirement alternatives; and second, a far more serious approach to reducing our frightening vulnerability to likely oil supply cut offs, by developing political support for what I believe is an urgent necessity—a major gasoline tax and a much enlarged strategic storage program.

But for now, I would argue the Reagan consensus, welcome and necessary, must focus on those issues that will help achieve the goal of any government—an unbroken rise in the real standard of living of its citizens. President Reagan has the support now to view inflation as Public Enemy #1; to reduce the rate of growth of Federal spending, budget deficits, and federal borrowing; to achieve regulatory reform; to encourage the Fed's stance on restrictive monetary growth; and to spur investment and productivity. Obviously, I believe that increased investment in its many forms—plant and equipment, R.&D., innovative technology—is the catalyst. This consensus provides us the unique opportunity now to put into place the necessary long-term economic policy that will strengthen our economy through the coming decade. The basic question to me is how can we achieve for our country the fullest potential over the longest term, at the earliest time of the President's brilliant political achievement.

We have seen references to an economic Dunkirk. The image that comes to my mind is we are indeed in a kind of historic, if not ultimate, battle, an economic and political Armageddon, not between good and evil, but between spending much less in the present and investing much more in our future versus our reverse and disastrous choice of the last two decades.

Is there really a choice?

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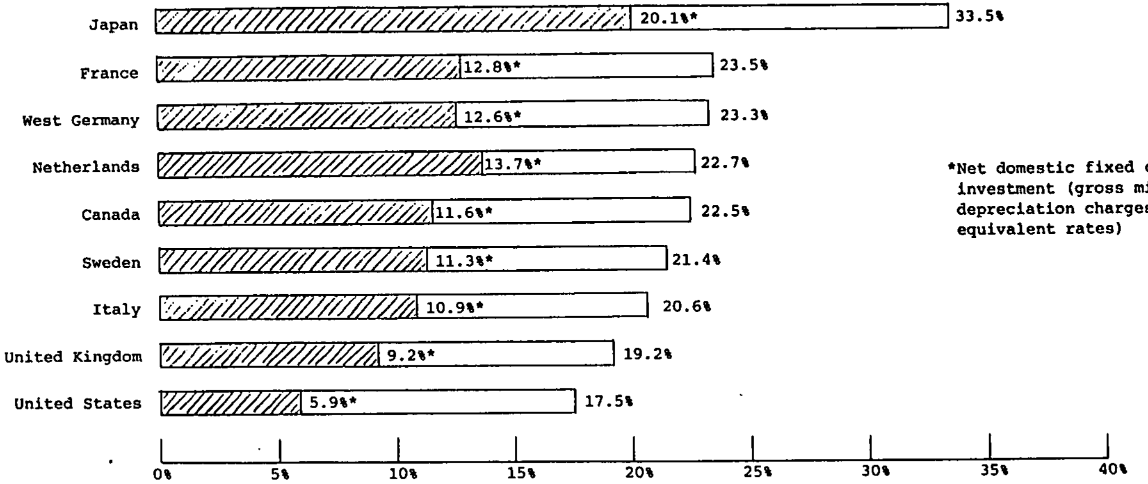
Table #1

Gross Domestic Fixed Capital Investment as Share of Gross Domestic Product
(Average Yearly, 1970-77)



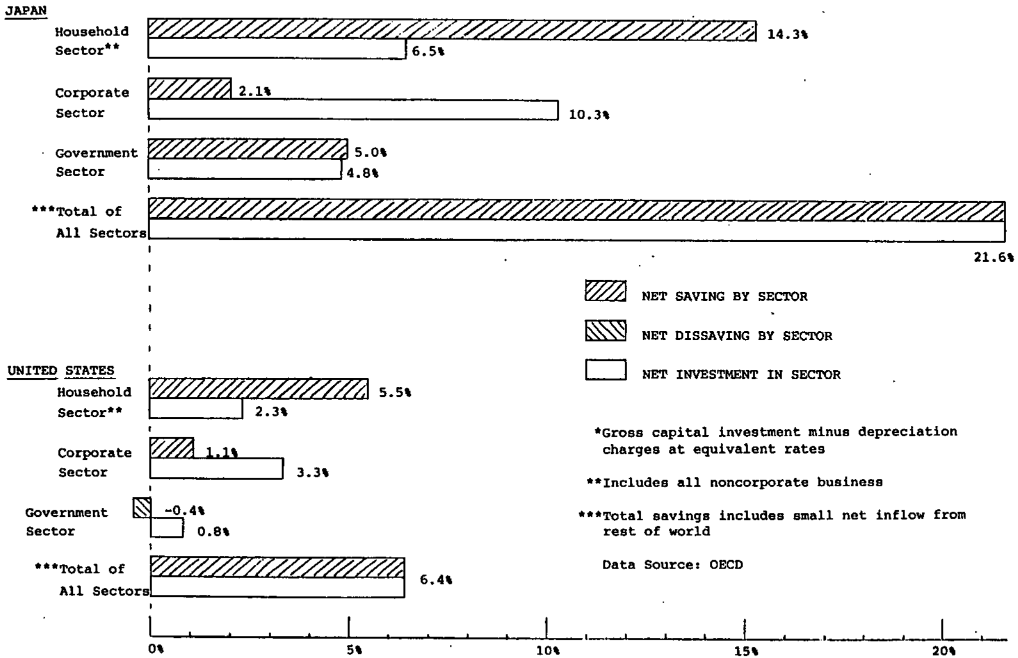
*Net domestic fixed capital investment (gross minus depreciation charges at equivalent rates)

Data Source: OECD

Table #2

The Savings Equals Investment Equation in Japan Versus the U.S.:

Net Domestic Savings and Investment* by Sector as Share of Gross Domestic Product (Average Yearly, 1970-77)



*Gross capital investment minus depreciation charges at equivalent rates

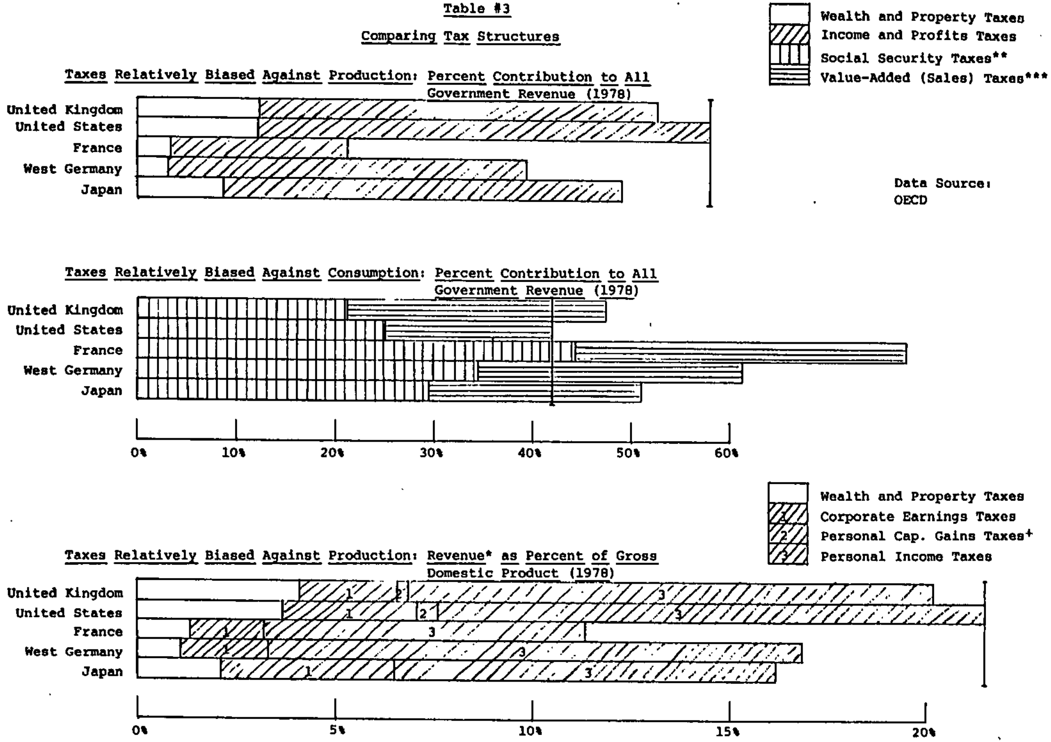
**Includes all noncorporate business

***Total savings includes small net inflow from rest of world

Data Source: OECD

Table #3

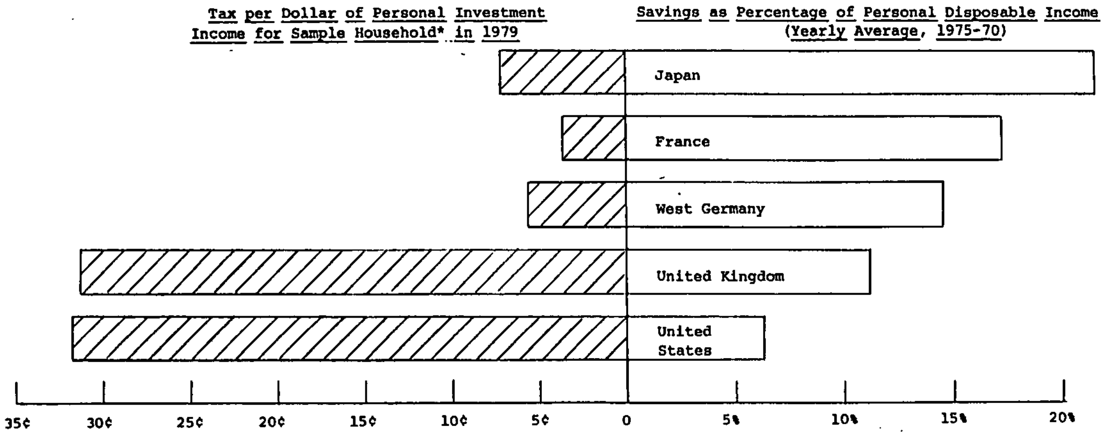
Comparing Tax Structures



*Central and local administrations
**Includes other minor tax revenues
***Includes all payroll taxes
+Undefined or near zero in France, West Germany, and Japan

Table #4

Comparing Investment Taxation and Personal Saving



*Sample Household (husband earns $50,000 in salary; 2 children; typical deductions) receives the following investment income: $10,000 in dividends
$5,000 in interest
$30,000 in long-term securities gains (net)
$4,000 in short-term securities gains (net)

Data Source: Price Waterhouse & Co.

Table #5: Tax Rates* on Savings for Family (2 children) Having Initial Earned Income of $40,000 per Year

Statutory Tax Rate on Gain
▨ Inflation-adjusted Tax Rate on Real Gain

	Calculation as of March, 79	United States (California)	United Kingdom	West Germany	Japan
Tax on Capital Gains	Stocks and bonds sold now for $3,000 bought for $2,000 in April 79	54.0%	0%**	19.7%**	0%
		▨ 66.8%	▨ 0%	▨ 24.4%	▨ 0%
	Stocks and bonds sold now for $3,000 bought for $2,000 in 1970	21.6%	0%**	0%	0%
		▨ (tax despite real loss)	▨ 0%	▨ 0%	▨ 0%
	Stocks and bonds sold now for $10,000 bought for $2,000 in 1970	21.6%	11.2%	0%	0%
		▨ 28.9%	▨ 39.3%	▨ 0%	▨ 0%
Tax on Interest Income	Past year's interest income on $10,000 of savings, where interest rate = inflation + 2%	54.0%	74.1%	0%**	0%***
		▨ 318.6%	▨ 429.8%	▨ 0%	▨ 0%
	Past year's interest income on $10,000 of savings, where interest rate = inflation - 2%	54.0%	74.1%	0%**	0%***
		▨ (tax despite real loss)	▨ (tax despite real loss)	▨ 0%	▨ 0%
Total Tax on Dividend Income (example: on $2,000 of distributed corporate earnings)****	Payable or witheld by corporation.........	46.0%	52.0%	36.0%	40.9%
	Payable by family......	26.5%**	22.1%	33.6%	17.7%
	Total.................	72.5%	74.1%	69.6%	58.6%
Tax on Estate or Inheritance	Parents deceased; $200,000 net financial wealth bequested to two children	16.4% (plus state tax and donee's income tax)	25.0% (plus donee's income tax)	1.8%	6.1%

*Assuming all standard deductions; including both central and local taxation; California residency for U.S. Current $ amounts are converted at current exchange rates; prior $ amounts are domestic currency fractions of current $ amounts.

**Due to or including threshold deductions

***Interest from savings up to $15,000 in postal savings or current deposit accounts, time deposit and national governmen bonds are tax-exempt.

****Not inflation-adjusted

THE U.S. COMPETITIVE POSITION IN THE 1980'S—AND SOME THINGS WE MIGHT DO ABOUT IT*

By Peter G. Peterson

It is enormously tempting at The Center for International Business to talk about just that, things international: international business, international economics, international trade, international development, international politics, and I, too, shall say something about out eroding economic position vis-a-vis our international competitors. But frankly, I think there has been entirely too much of this strictly international talk. We have foreign policy people who talk about foreign policy as though it were a thing apart. We have international trade people who talk about trade as though it exists in a water-tight compartment. Foreign aid people often talk in the same way. However, it seems to me that, like charity, economic and political strength begin at home.

I simply state that obvious truth that we cannot be strong abroad if we are weak at home; that if our economic well-being, and our dollar and our political will are eroding at home then it is virtually inevitable that our international position will also erode. This is true not just because we do not create the resources to invest in defense and other international initiatives -- though this is an imperative -- but because leadership is both substance and perception. We simply cannot be a leader in the world if our economy and its inevitable partner, our confidence, is perceived as faltering.

Some would say that what Mr. Peterson is urging is a return of economic macho, of being No. 1 just for the sake of being No. 1. Thus,I think we might ask, what difference does it make to the world if our economic position continues to erode? I would hope we know what difference it makes to ourselves. Let us ask ourselves what difference does it make to the world. The irony of this -- something both Japan and West Germany would be the first to tell you -- is that they could not and would not assume America's responsibilities for political leadership and that they see no alternative to leadership other than the United States. And yet with our very lives at stake, we have somehow managed a brilliant communication miracle: we have transformed the issue of our productivity "decline" (some would say "collapse") into what we

*From a transcript of a talk presented at The Center for International Business by Mr. Peterson on October 28, 1980 to The Special Briefing, "The Challenge of a Changing World Economy: What Will It Mean for Multinational Companies?"

in the Nixon Administration used to call a "MEGO subject," which is an acronym for "Mine Eyes Glaze Over." Even more than MEGO, the political realities flowing from our economic position combine unusual amounts of ignorance and apathy. I am reminded of the philosophy professor you may have heard about who asked his class, "which is worse, ignorance or apathy?" Some sleepy student from the back of the room mutters out, "I don't know and I don't care."

To make my message more vivid and less painful, I have updated some charts from my early White House days on the position of the United States in the world and what we have been doing -- or I should say not doing -- with our resources. The good news is that I shall show you only half of the charts. The bad news is what is on the charts themselves.

Lack of Productivity Growth Equals Lack of Real Income Growth

The first point that I would like to make on this MEGO business is that what has been going on for the last six or seven years is not just an abstraction to be discussed only at The Center for International Business. It has a lot to do with the standard of living of the American people. As you can see, previous generations got used to an American expectation that their standard of living would roughly double every generation. But for the last six or seven years, there has been virtually no increase in the real income of our workers. [Chart 1] Now some would ask, what difference would this make if this trend continues? The difference by the year 2000, which is only 20 years from now, is a difference of nearly $6,000 or 60% in real disposable income -- for there is almost a perfect correlation between productivity increases and real income. So while we will talk at this meeting about international economic and political realities, let us not forget that what we are also talking about is the standard of living of our people at home. I will let the political philosophers among you ponder on the social consequences of another twenty years with no increase in the real income of our people and very little, therefore, to redistribute to others.

You can see that, in the terms of world GNP, there has continued to be a significant reduction in America's share of the world's income. [Chart 2] Remember how glibly we used to talk about how the U.S. had a third of the world's income? Well, we are nearly down to a fifth. Here we can see the magnitude of the increase in two countries, particularly Japan, which has almost quadrupled its share of world income in only twenty years. You can see that our Communist friends, if that is the right word, are not making much progress either.

Chart 1

U.S. STANDARD OF LIVING: POTENTIAL vs ACTUAL

(REAL DISPOSABLE PERSONAL INCOME PER CIVILIAN EMPLOYEE)

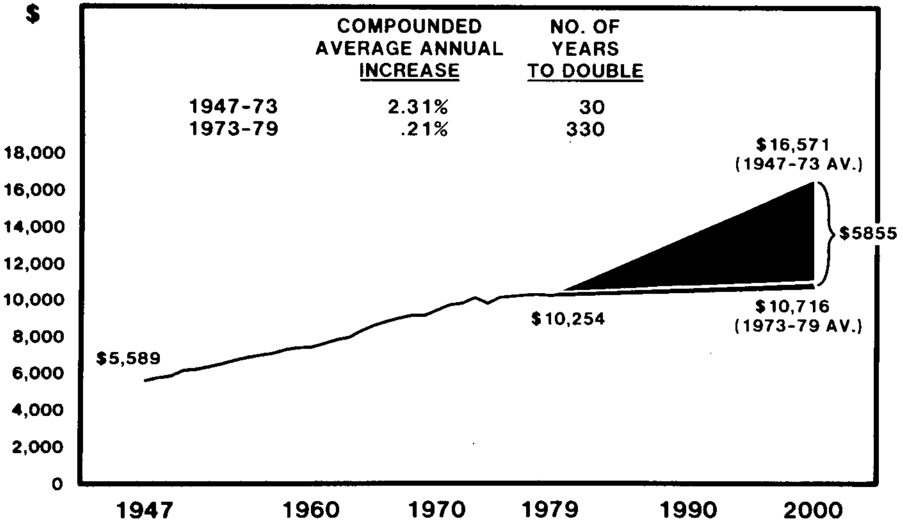
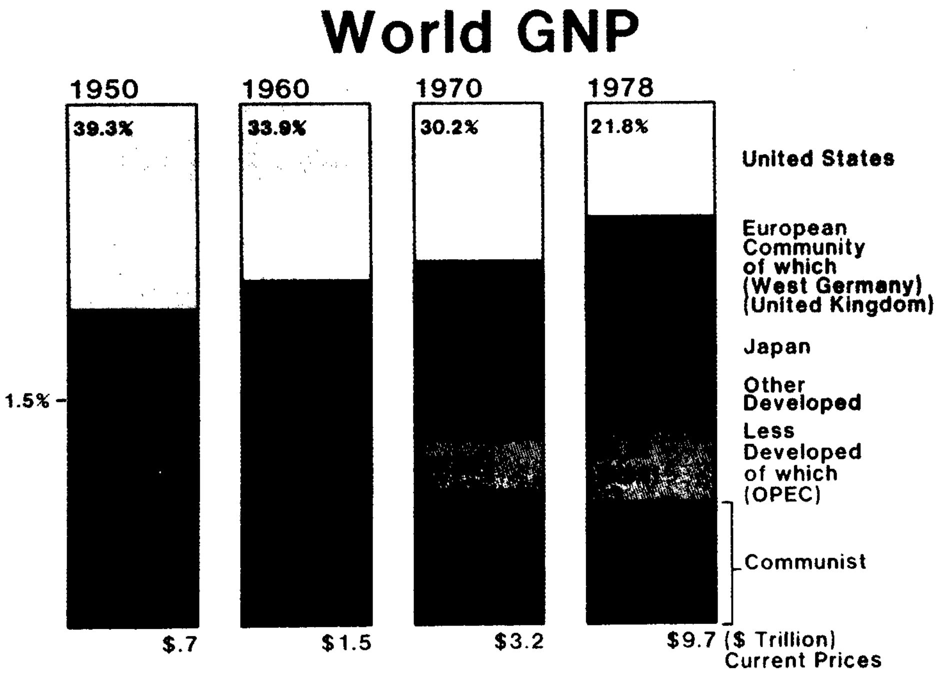


CHART 2


World GNP
1950
1960
1970
1978
39.3%
33.9%
30.2%
21.8%
1.5%
United States
European
Community
of which
(West Germany)
(United Kingdom)
Japan
Other
Developed
Less
Developed
of which
(OPEC)
Communist
$.7
$1.5
$3.2
$9.7 ($ Trillion)
Current Prices

Have the Japanese and West German Economies Made Trade-offs Between Real Growth, Unemployment, Inflation, Interest Rates, and Exchange Rates?

We have been told by some that there are trade-offs between real growth, unemployment, inflation, and interest rates, and that we could not, at the same time, do well in all of these crucial indicators. But if you take the longer perspective of these charts and you look at the U.S. and the U.K. economies on the one hand -- all too often our relative performance tends to group us together -- it does not make much difference whether you are looking at rates of inflation [Chart 3] where you can see that there was a post-1973 bulge (although here again, the Japanese and German economies are now doing vastly better than we are), whether you are looking at interest rates [Chart 6], whether you are looking at exchange rates [Chart 7], unemployment [Chart 8], or indeed almost any indicator on the domestic front. The Japanese and German economies, confronted with far more serious problems and commanding far less resources than we, have done substantially better on all counts. We and the U.K. have had two to three times their unemployment rates, two to three times their levels of interest rates, and two to three times their inflation rates. Speaking of prolonged and high inflation, Chart 5 shows what a dollar would be worth in 20 years under varying rates. Let us hope we don't need to learn this lesson the way Germany did.

CHART 3

GROWTH IN INFLATION
(CONSUMER PRICE INCREASES)

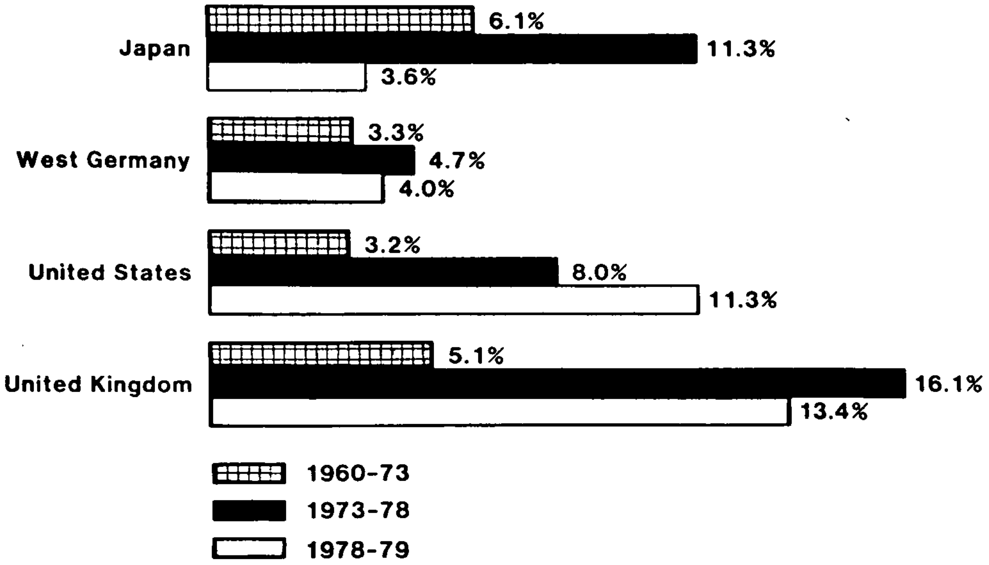


CHART 6

INTEREST RATES

(Central Bank Discount Rates)
(1970-1979; Year-end Rates)

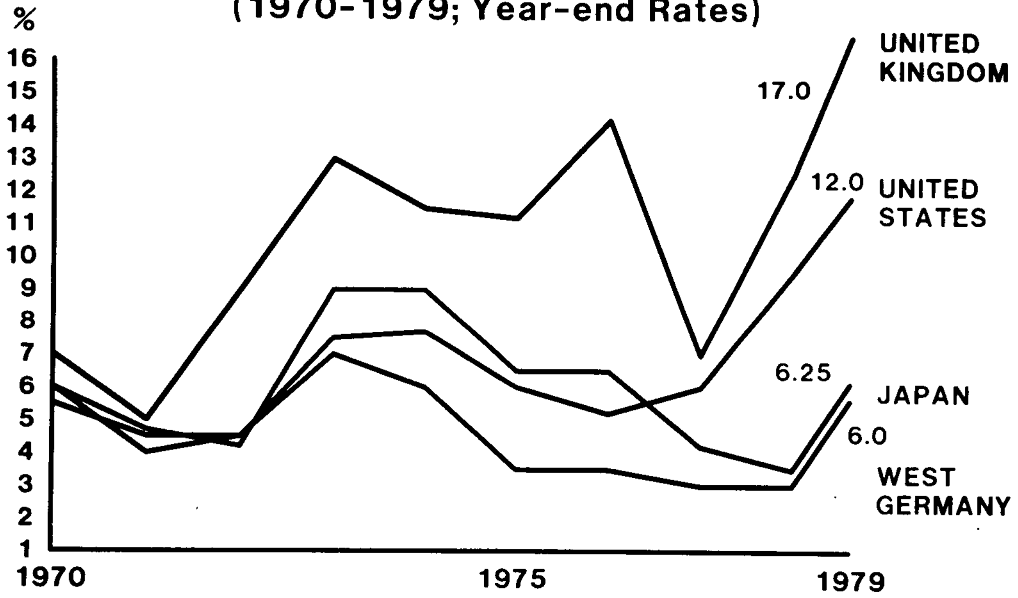


CHART 7

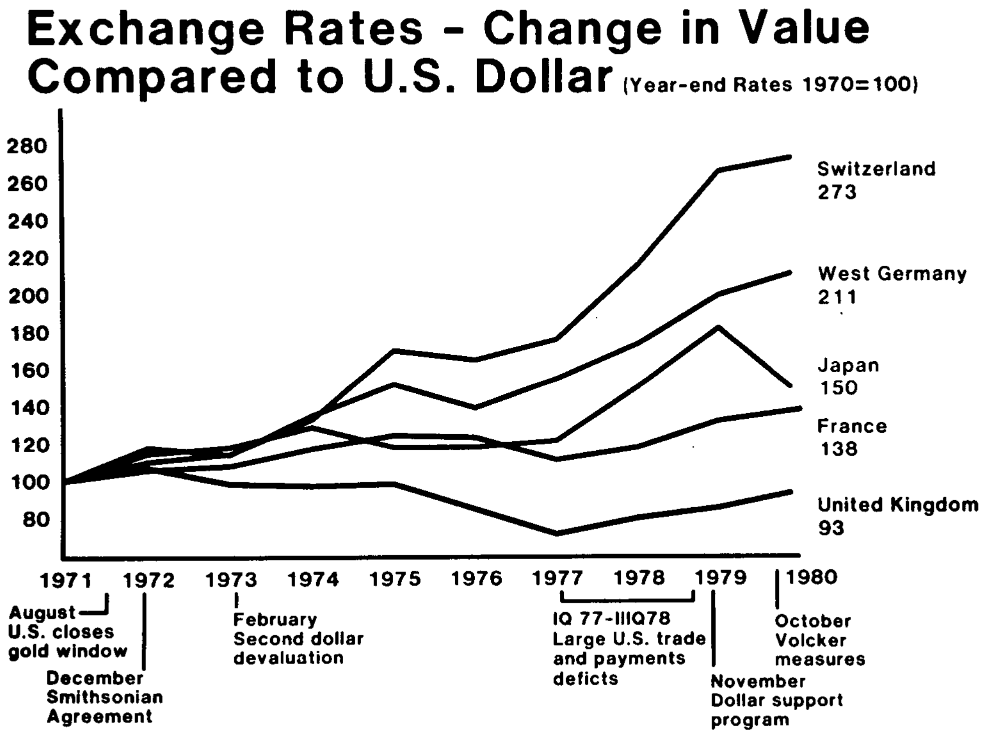

Exchange Rates - Change in Value Compared to U.S. Dollar (Year-end Rates 1970=100)
280
260
240
220
200
180
160
140
120
100
80
Switzerland 273
West Germany 211
Japan 150
France 138
United Kingdom 93
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
August U.S. closes gold window
December Smithsonian Agreement
February Second dollar devaluation
IQ 77-IIIQ78 Large U.S. trade and payments deficts
November Dollar support program
October Volcker measures

CHART 8

UNEMPLOYMENT RATE
1960-1979
(ADJUSTED TO U.S. CONCEPTS)

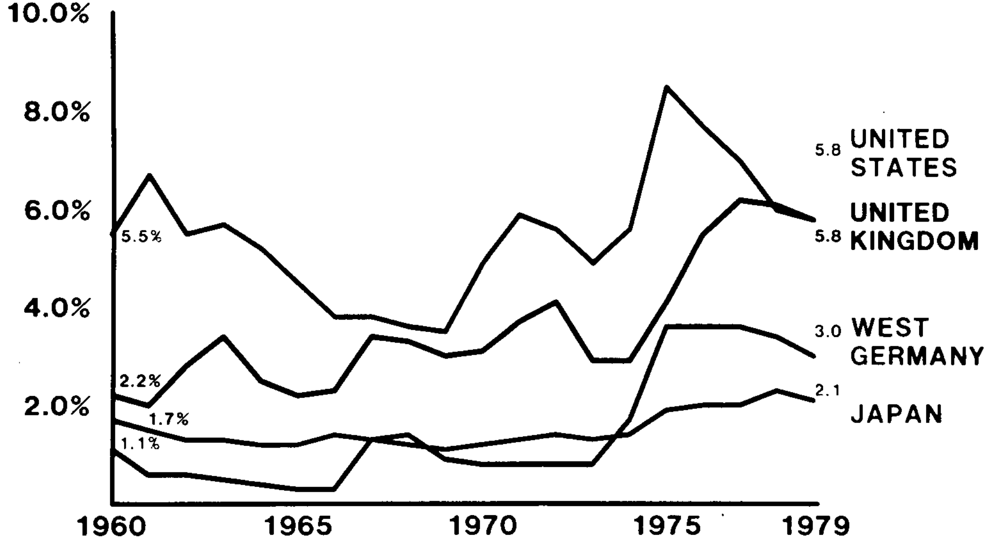
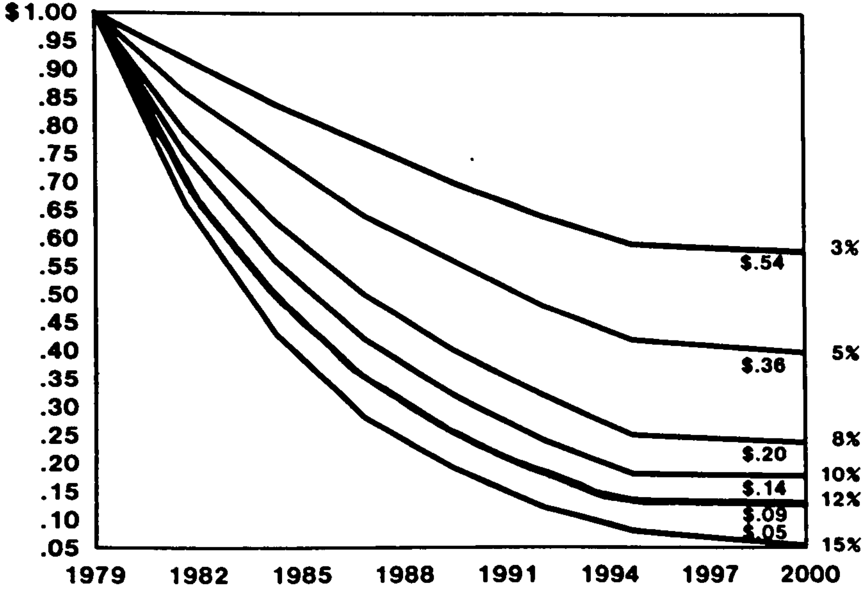


CHART 5

Long Run Effect Of Continuous Inflation



Finally, I would like to take this newest cliche, productivity, and put it even more in an historical context. If you will look at the lines on this chart [Chart 13] that take the period between 1870 and 1950, you will see a difference of somewhere between .6% and .8% in the annual growth trends of our productivity versus that of the United Kingdom, West Germany, and Japan. That small difference, compounded over 80 years, was the decisive difference that made the United States the economic and the political leader in the world. Yet look at the blue columns and remember where we are now -- remembering in 1979 and 1980 we have actually had a net decline -- and I want all of us now to imagine what this world be like in another ten years [Chart 14] if we should have productivity differences not of .6% but <u>differences of 3 and 4 and 5 full percentage points compounded vis-a-vis the rest of the world.</u> What will we be by the year 1990? And how will we be perceived?

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CHART 13

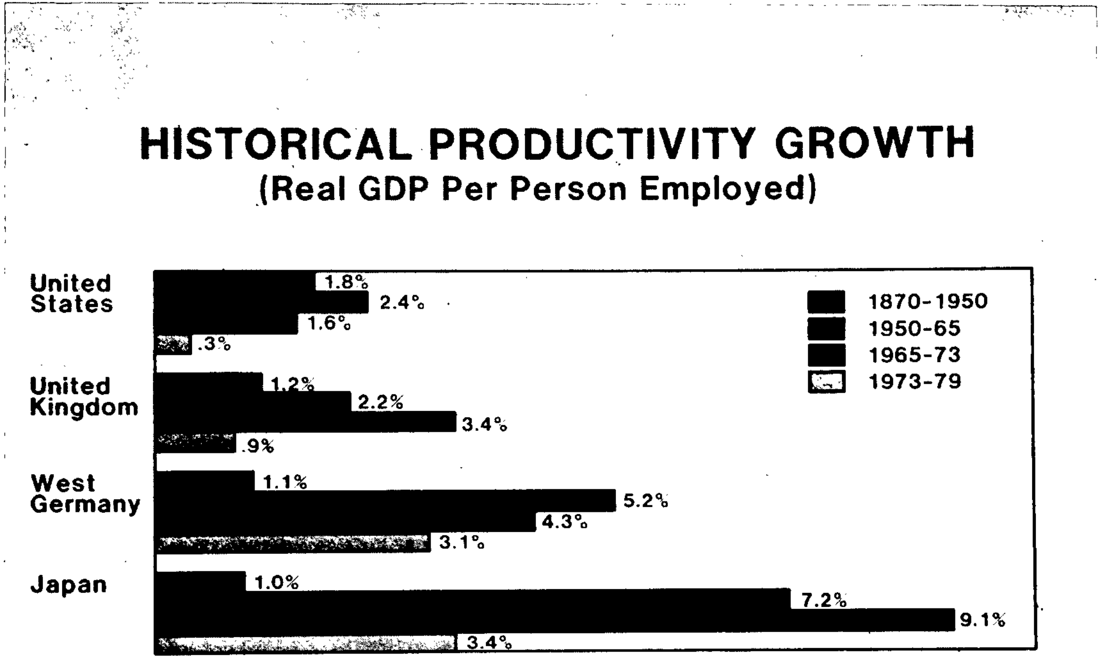
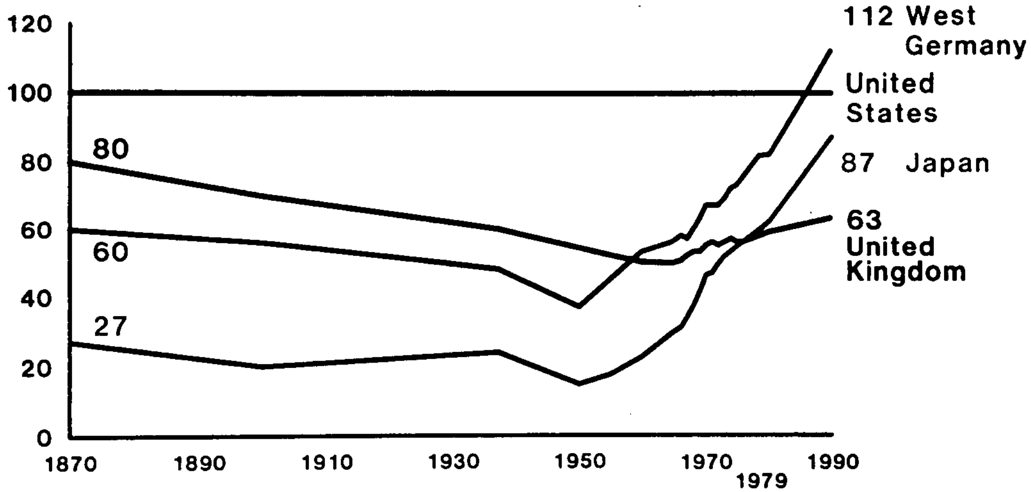


Chart 14

Relative Productivity Growth*
Real GDP Per Person Employed
(US=100)



* 1979-1990 is an extrapolation of 1973-1979 average annual compounded growth

Some Case Studies in the New Drop in Manufacturing Competitiveness -- Automobiles, Color Television Sets, and Integrated Circuit Chips

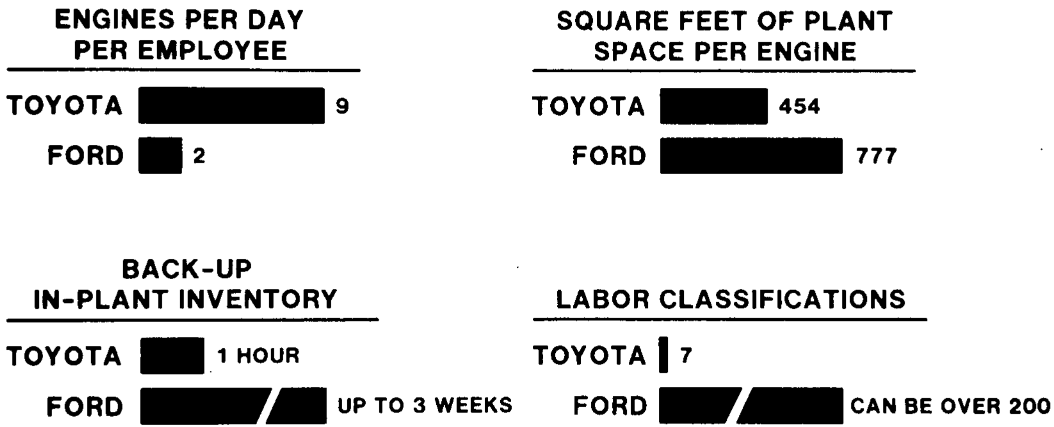
Of course, our position in manufacturing, in particular, has significantly deteriorated. Though I will talk a bit about some of the general reasons, I do not want to approach this productivity problem strictly at a macro or global level. Most of us, whether we care to admit it or not, are anecdotalists at heart. We like case studies and we like examples. So let me take you briefly through three products.

One theme that runs through all of these case studies is that Japanese productivity and much lower cost have not been achieved at the expense of quality. Quite the contrary. The Japanese quality, if anything, seems better. In the case of automobiles, for example, I am told that Rent-A-Car firms find that the number of breakdowns and the cost of servicing American cars are often two times or more greater than on well-known Japanese import cars. Also, the relative resale value of Japanese cars has been substantially higher than their American counterpart; indeed it was reported to me that the Japanese cars' resale price is about 10% higher than their original cost to the Rent-A-Car firms. It seems apparent that the Japanese cars' superior durability, at least as perceived by the consumer buyer, is a principal reason for the higher resale value.

Here are some numbers that compare a few of Ford Motor's and Toyota's more efficient plants in the world. This is material that Ford itself has released. [Chart 19] Notice the profound difference in output in engines per day, in the square feet of plant per engine, the almost shocking differences in backup inventory, in work-process inventory, and in labor grade classifications (seven versus something over two hundred). This Ford study went on to point out that Toyota produced equivalent number of cars with many fewer plant labor but also many fewer salaried and staff people. Indeed, Toyota, compared to Ford Europe, produced twice the number of cars with less than half of the number of organization levels.

CHART 19

DIFFERENCES IN FORD VS. TOYOTA MANUFACTURE



TOYOTA'S KANIGO PLANTS SAMPLE OF BETTER FORD'S PLANTS

Now let us look at some work done on color television sets. You may be interested in where I have obtained this material. Some manufacturers have apparently been hiring management consultants to do cost studies in conjunction with certain dumping cases, based on the assumption that the Japanese, for example, were doing a lot of dumping. But what has emerged in some of these studies (which have not been made terribly public, perhaps for good reasons) is that in many cases there are real, inherent cost differences in the manufacturing and design of these products.

This chart tells the story of the reliability of television sets, measured in service calls during the warranty period. [Chart 20] You can see that we are doing considerably better than we were, but you can also see that the Japanese manufacturers still had significantly fewer service calls in 1977. Typically, costs are designed out of products and quality is designed into products. Some years ago, Japanese manufacturers of color TV sets, concerned about rising repair costs, mounted a major redesign effort to achieve this higher reliability.

Here is the number of direct labor hours per color television set. [Chart 21] The U.S. producers have up until recently felt quite good about the progress they have made. They took, as you can see, two-and-one-half to three-and-one-half hours out of the sets between 1970 and 1978. [Chart 22] In spite of greatly increased costs per direct labor hour, you can see that U.S. producers have kept the costs per unit pretty much where they are. This looks very good until one looks at the typical Japanese producer who reduced direct labor hours by about two-thirds from 5 1/2 to 1.7 hours and -- with a total hourly labor cost higher than ours -- showed an annual compounded productivity gain of 33%. This has resulted in a product that costs substantially less than the American product even though the reliability is apparently higher. One, but only one, of the contributing factors is more automation: substantially more automatic insertion of printed circuit boards. [Chart 23]

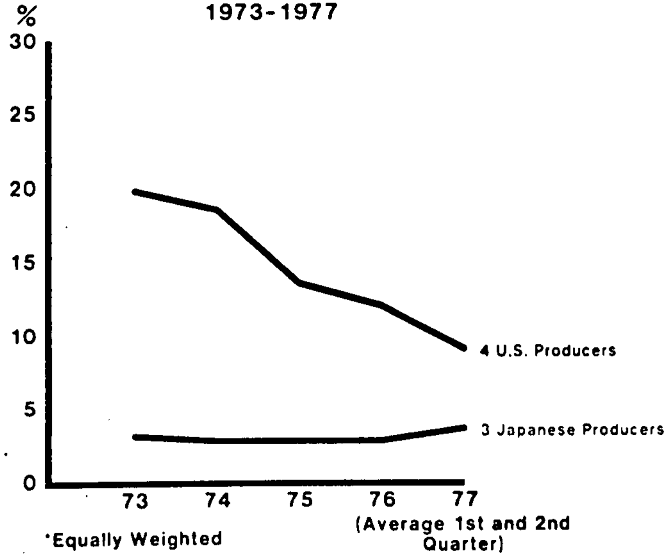
On the quality front, I was particularly interested in the Hewlett-Packard study on integrated circuit chips. [Chart 24] I am taking some of these higher technology products as examples to get us out of the textiles and shoes trade rhetoric of the sixties. On the far right hand column, using Hewlett-Packard's own quality index, two themes emerge. The Japanese products not only show a higher level of quality, but there is substantially less variation among the Japanese manufacturers with regard to quality. We see, in other words, the same pattern that has been observed in automobiles and color T.V. sets.

So, this productivity issue, which we tend to treat at the rather global or macro level, discloses some very important managerial aspects -- in the broadest sense of that word, "managerial". It is not simply a matter of increased national levels of saving and levels of investment.

CHART 20

PERCENT OF POPULATION OF COLOR TV SETS REQUIRING SERVICE CALLS DURING WARRANTY STAGE

1973-1977

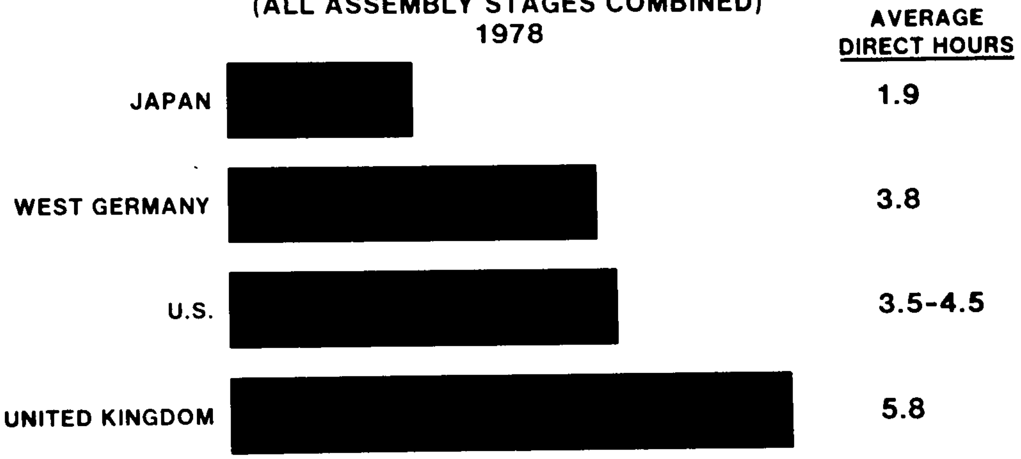


*Equally Weighted

CHART 21

DIRECT LABOR HOURS PER COLOR TELEVISION SET

AVERAGE OF MAJOR NATIONAL PRODUCERS
(ALL ASSEMBLY STAGES COMBINED)
1978



ASSEMBLY STAGES INCLUDE PRINTED CIRCUIT BOARD, CHASSIS, AND FINAL

CHART 22

LABOR COST PER SET FOR COMBINED ASSEMBLY STAGES OF COLOR TELEVISION SETS

HYPOTHETICAL U.S. VERSUS JAPANESE SET PRODUCERS (AT CURRENT DOLLARS AND CURRENT EXCHANGE RATE)

	U.S. PRODUCER	JAPANESE PRODUCER
1970	\$23.50 - \$28.00 (6.0 - 7.1 HOURS X \$4.00)	\$8.80 (5.5 HOURS X \$1.60)
1978	\$29.60 (3.5 HOURS X \$7.60)	\$15.10 (1.7 HOURS X \$8.90)
IMPLIED ANNUAL PRODUCTIVITY GAIN IN ASSEMBLY	7 - 10%	33%

CHART 23

PERCENT AUTOMATIC INSERTION IN PRINTED CIRCUIT BOARDS OF MAJOR NATIONAL PRODUCERS OF COLOR T.V. SETS

1978

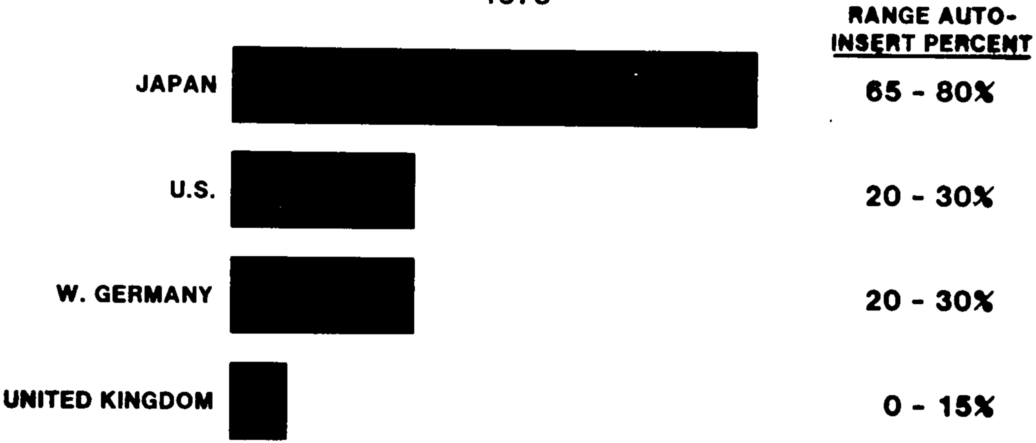


CHART 24

HEWLETT - PACKARD'S QUALITY EXPERIENCE WITH U.S. VS. JAPANESE MANUFACTURERS INTEGRATED CIRCUIT "CHIPS" (FOUR - MONTH SAMPLING PERIOD)

	% FAILED TEST ON ARRIVAL	% FIELD FAILURE PER 1,000 HRS	H-P's QUALITY INDEX
JAPANESE CHIPMAKERS			
A	0	0.010	89.9
B	0	0.019	87.2
C	0	0.012	87.2
AMERICAN CHIPMAKERS			
X	0.19	0.090	86.1
Y	0.11	0.059	63.3
Z	0.19	0.267	48.1

Much Less Investment Than Our Principal Competitors

Let us move now to the macro level. We all know that the Japanese and German economies have saved considerably more than we have, [Chart 25] and this fact, of course, translates into substantially higher levels of investment, as you can see on these charts. [Charts 27 & 28] We are not in an enviable position. Substantially older plant and equipment are, of course, an inevitable result. [Chart 29] Many with whom I have discussed this say, "Well, these countries simply remodeled their plants after the War." It does not take a sophisticated grasp of arithmetic to see that if the average age of Japanese plant and equipment is only ten years -- some would say eight years -- then we are concerned with a period long after the end of World War II, which as I recall was something like 1945 and not the early seventies which is what this explanation would imply. Incidentally, this year, with an economy half the size of ours, the Japanese will achieve the extraordinary landmark of spending more on plant and equipment in absolute terms than the U.S.

During the period covered by these charts, our companies have obviously invested very substantial amounts abroad. [Chart 31] Thus, you will notice that in 1978 we still had four times as much invested abroad as was invested by foreign companies in this country. You would not know this by reading some of the headlines implying we are being "taken over" by "furreigners" and so forth, but those are the facts.

The Financial Market's Response to Poor Profit Performance

Our poor economic and profit performance has also been reflected in the marketplace. In the stock market, for example, we see in Chart 33 a negative real rate of return: obviously the investors are discounting the future rather heavily. What has happened of course is that companies, knowing the high cost of equity capital, have dramatically increased their dependence on debt [Chart 39] and their strained balance sheets increasingly reflect it.

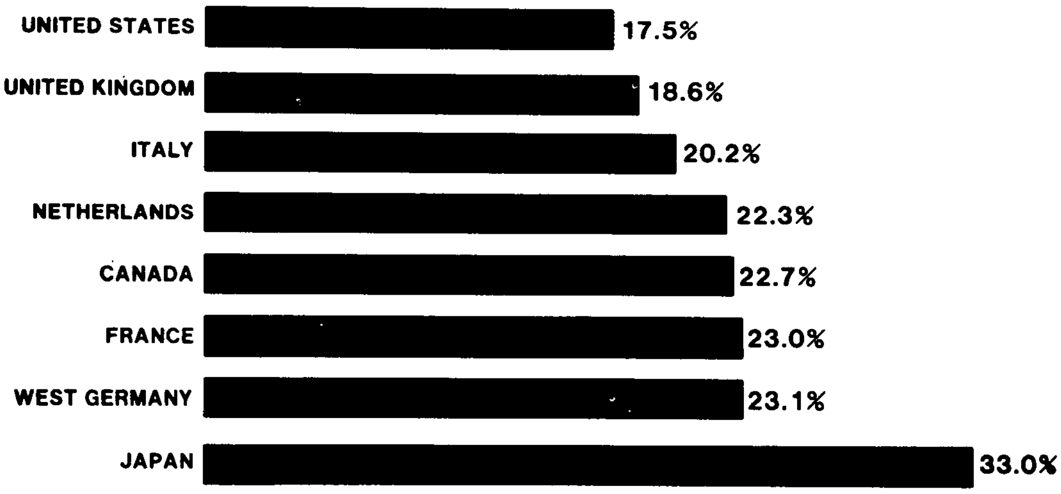
Chart 25

LEVEL AND COMPOSITION OF SAVINGS
(AS SHARE OF GDP)
(1970-77)

	CONSUMPTION OF FIXED CAPITAL	GOVERNMENT	CORPORATE	HOUSEHOLD	TOTAL DOMESTIC SAVINGS
UNITED STATES	11.6%	-0.4%	1.1%	5.3%	17.6%
UNITED KINGDOM	10.0	2.1	.4	5.6	18.1
WEST GERMANY	10.7	3.6	1.9	8.9	25.1
JAPAN	13.3	5.0	2.1	14.4	34.8

CHART 27

GROSS FIXED CAPITAL FORMATION AS A SHARE OF GNP
(1970-79 AVERAGE)



PRIVATE AND GOVERNMENT SECTORS EXCEPT MILITARY

CHART 28

PRIVATE INVESTMENT IN PLANT AND EQUIPMENT

(AS A SHARE OF GNP)(1970-78 AVERAGE)

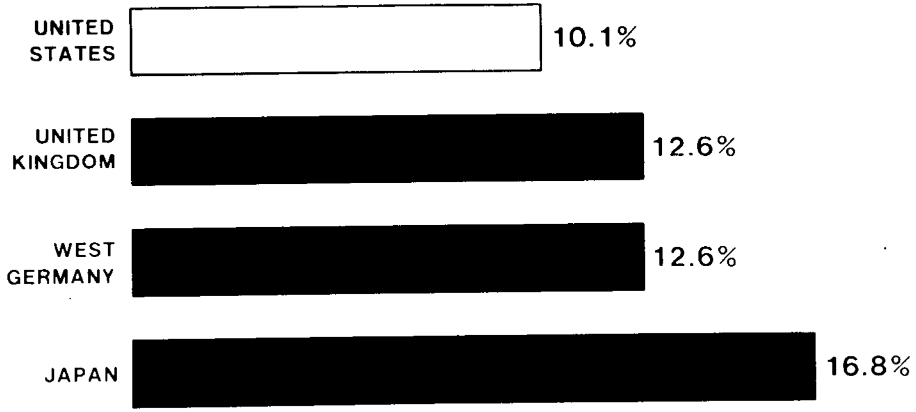


Chart 29

ESTIMATED AVERAGE AGE OF PLANT AND EQUIPMENT

(YEARS) (1978)

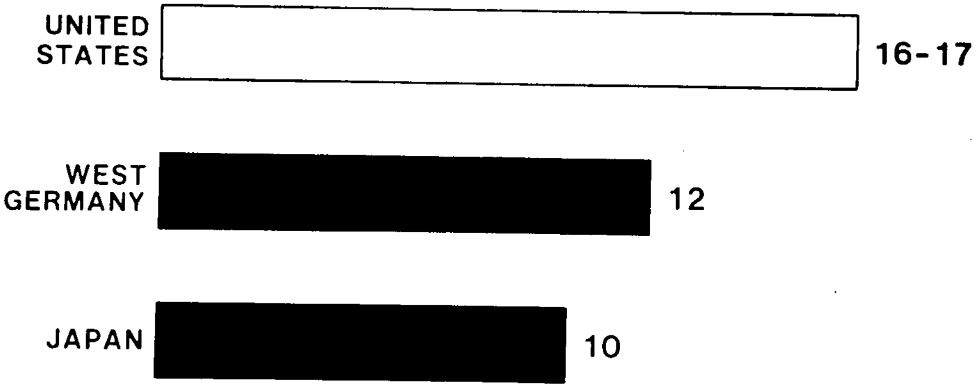
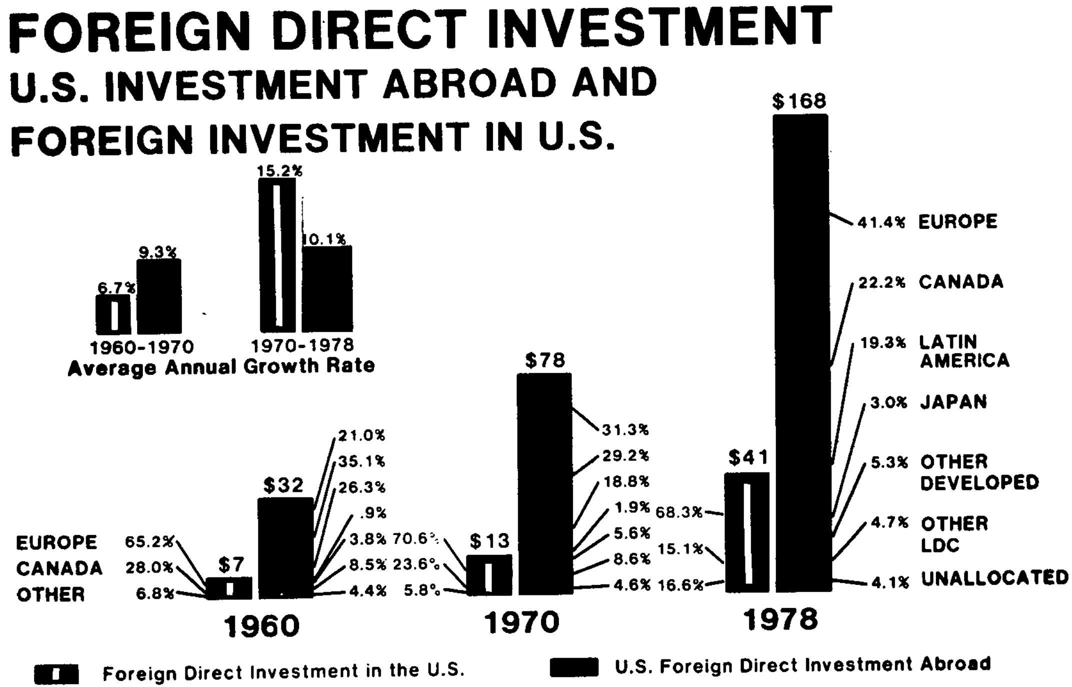


CHART 31


FOREIGN DIRECT INVESTMENT
U.S. INVESTMENT ABROAD AND
FOREIGN INVESTMENT IN U.S.
6.7%
9.3%
15.2%
10.1%
1960-1970
1970-1978
Average Annual Growth Rate
$7
$32
$13
$78
$41
$168
EUROPE 65.2%
CANADA 28.0%
OTHER 6.8%
21.0%
35.1%
26.3%
.9%
3.8%
8.5%
4.4%
70.6%
23.6%
5.8%
31.3%
29.2%
18.8%
1.9%
5.6%
8.6%
4.6%
68.3%
15.1%
16.6%
41.4% EUROPE
22.2% CANADA
19.3% LATIN AMERICA
3.0% JAPAN
5.3% OTHER DEVELOPED
4.7% OTHER LDC
4.1% UNALLOCATED
1960
1970
1978
Foreign Direct Investment in the U.S.
U.S. Foreign Direct Investment Abroad

81-489 O - 81 - 4

CHART 33

5-YR. AVERAGE RETURN ON STOCKS AND BONDS - AFTER INFLATIONARY EFFECT

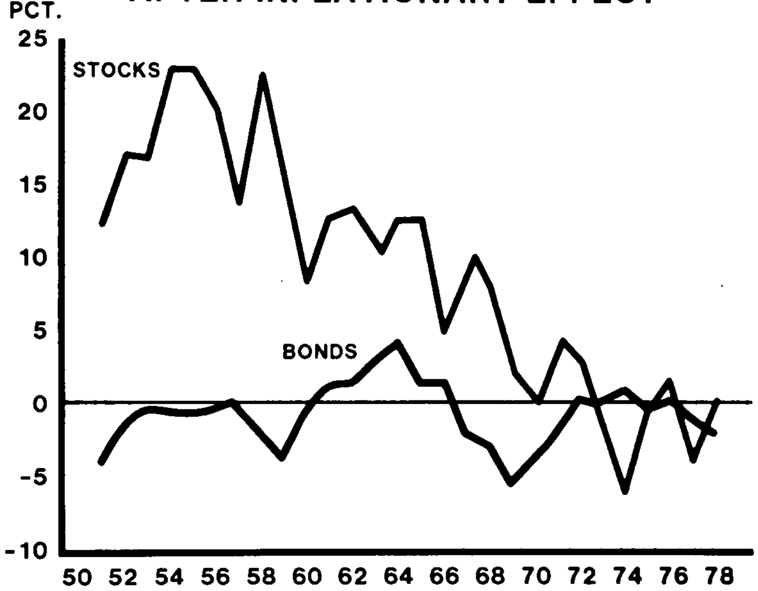
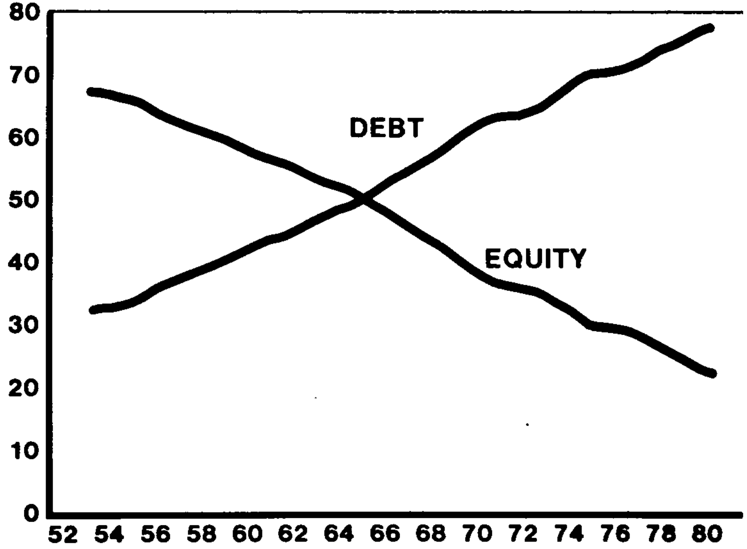


CHART 39

PERCENT OF TOTAL NEW CAPITAL RAISED BY NON-FINANCIAL CORPORATIONS—DEBT VS. EQUITY

PCT.



Slipping Performance in Technological, Innovative Performance

There is nothing in my opinion that is more important to reinvigorating this economy than a new concentration on research and development. I want you to notice first of all the very substantial, relative drop in our R&D investment, particularly vis-a-vis Japan and West Germany. If I had pushed Chart 47 back another ten to fifteen years to include the early 1950's to the 1960's, we would see that we doubled during that period our share of GNP going into R&D.

There are also significant trends taking place in the number of scientists and engineers. [Chart 49] In the last decade, we saw a drop of about a quarter in the number of Ph.D graduates in engineering. This is not a trend you reverse overnight. It was not many years ago that we produced the same number of lawyers as electrical engineers out of our colleges. We are today producing twice as many lawyers. I think that says two things about our country -- both of them lamentable.

Patents granted are clearly something to be looked at -- as an early indicator of future innovation trends. The trends in innovation have in previous years been moving against us. [Chart 51] In Chart 52 you will be interested in the growth level in U.S. patents, or I should say the lack of growth. You will notice between 1968 and 1978, for example, there is either no growth or there is an absolute decline with regard to patents issued to U.S. citizens or institutions. Vis-a-vis the Japanese at the present time I am told that we actually have a negative patent balance; that is, there are now more patents being issued in the United States to Japanese than are being issued in Japan to Americans. I have examined these patent trends in four different but crucial product areas and the trend is troubling in all four of them. [Chart 53] Along with self-imposed regulatory burdens we see this resulting in disheartening effects on the introduction of new drug chemical entities. [Chart 55] As in all these cases, the fact that much of the debilitation of U.S. innovativeness by government actions may have been unintentional makes it no less debilitating.

Now, in my business, we look for market indices of what is going on. Every study of technological innovation, which has been the source of so much of our economic strength in our country, reveals that the smaller technical companies -- the earlier Xeroxes, Polaroids, Texas Instruments, and Hewlett-Packards -- have accounted for somewhere between 50% and 70% of the major commercial innovations. Clearly there has been a major drop in the number of smaller companies coming to the market, although there has been some uplift in the last few years subsequent to the change in the capital gains rate. [Chart 56]

Chart 47

National R&D Expenditures as a Share of GNP

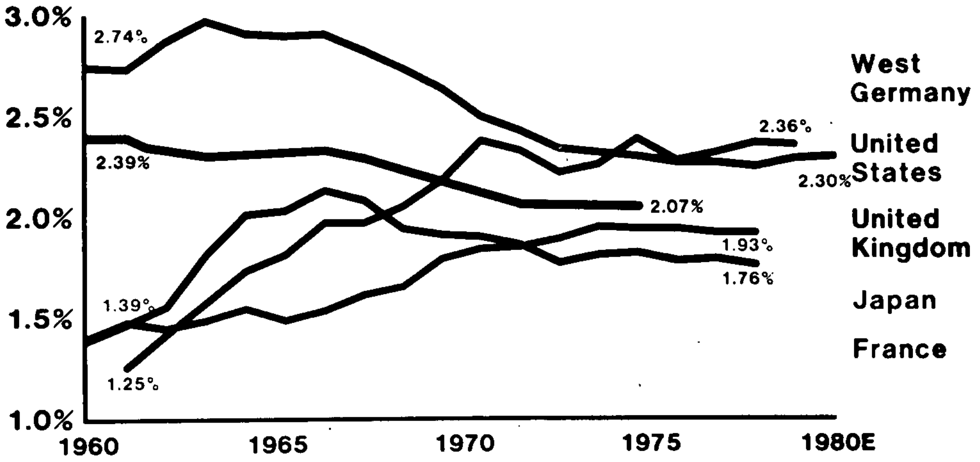
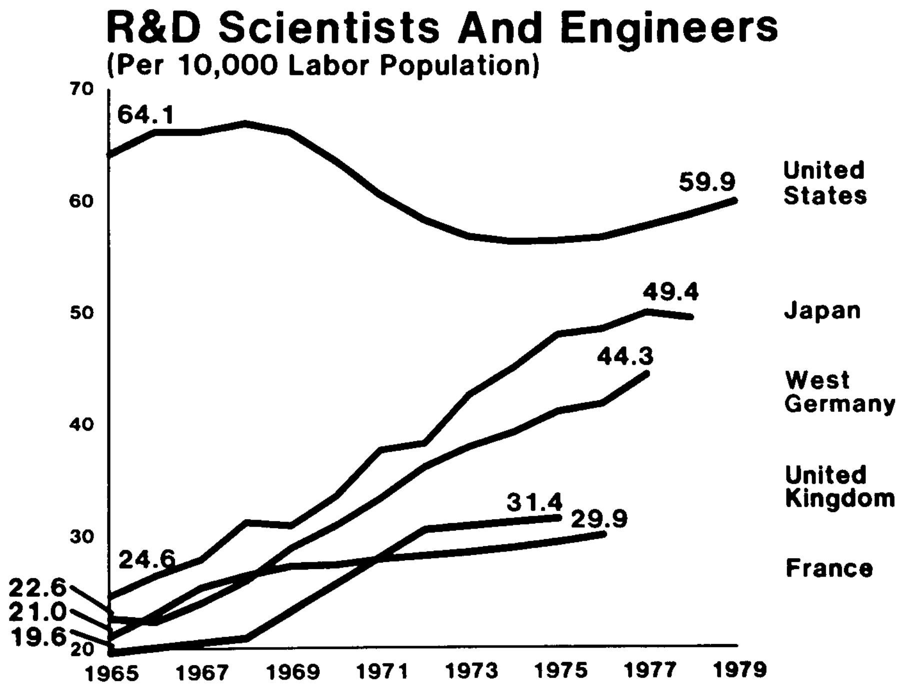


CHART 49



R&D Scientists And Engineers
(Per 10,000 Labor Population)
70
60
50
40
30
20
64.1
59.9
49.4
44.3
31.4
29.9
24.6
22.6
21.0
19.6
1965
1967
1969
1971
1973
1975
1977
1979
United States
Japan
West Germany
United Kingdom
France

CHART 51

SHARE OF MAJOR TECHNOLOGICAL INNOVATIONS ORIGINATING IN U.S. , W. GERMANY AND JAPAN

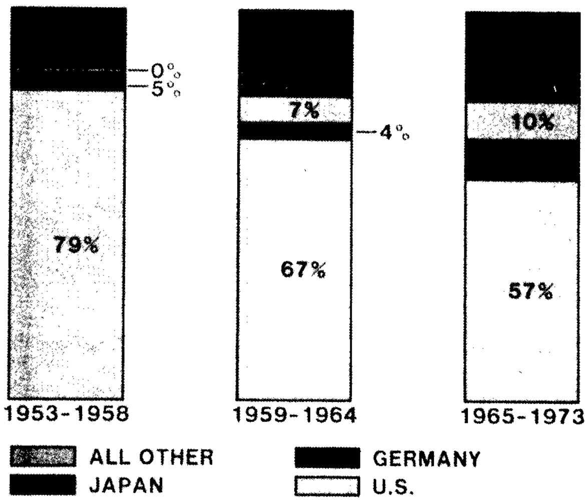


CHART 52

U.S. Patents Granted

TOTAL PATENTS

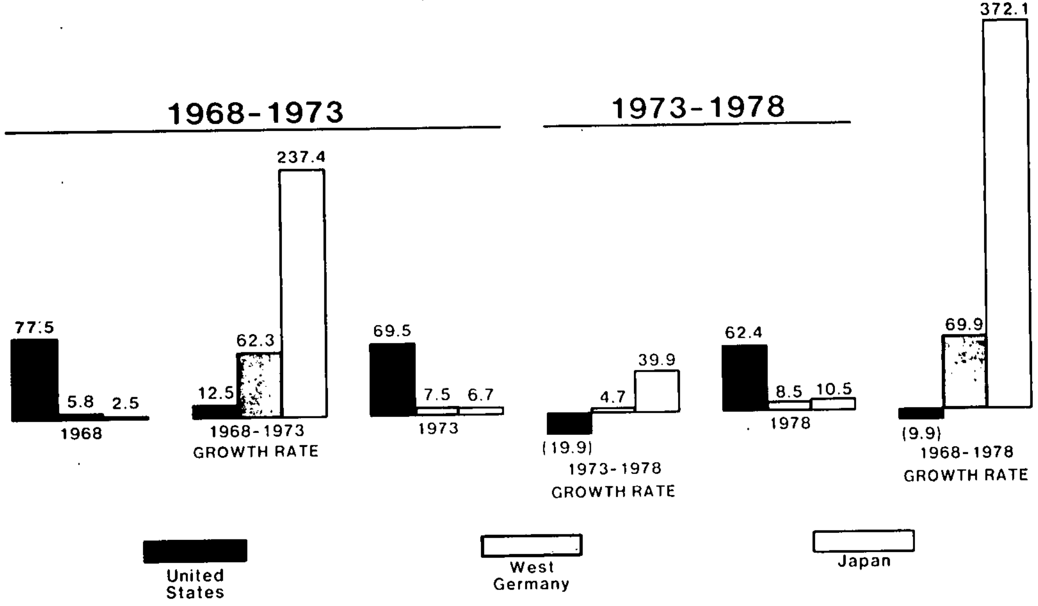


CHART 53

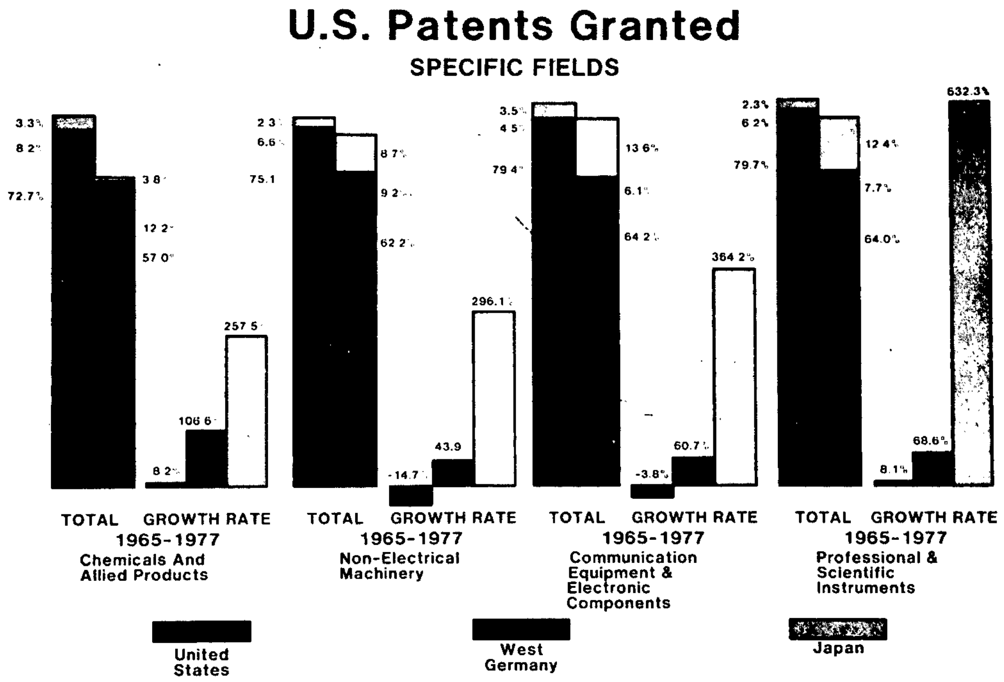

U.S. Patents Granted
SPECIFIC FIELDS
TOTAL
GROWTH RATE
1965-1977
Chemicals And Allied Products
Non-Electrical Machinery
Communication Equipment & Electronic Components
Professional & Scientific Instruments
72.7%
257 5
106 6
75.1
296.1
43.9
-14.7
79 4
364 2%
60.7
-3.8%
79.7%
632.3%
68.6%
8.1%
64.0%
United States
West Germany
Japan

CHART 55

U.S. NEW CHEMICAL ENTITIES

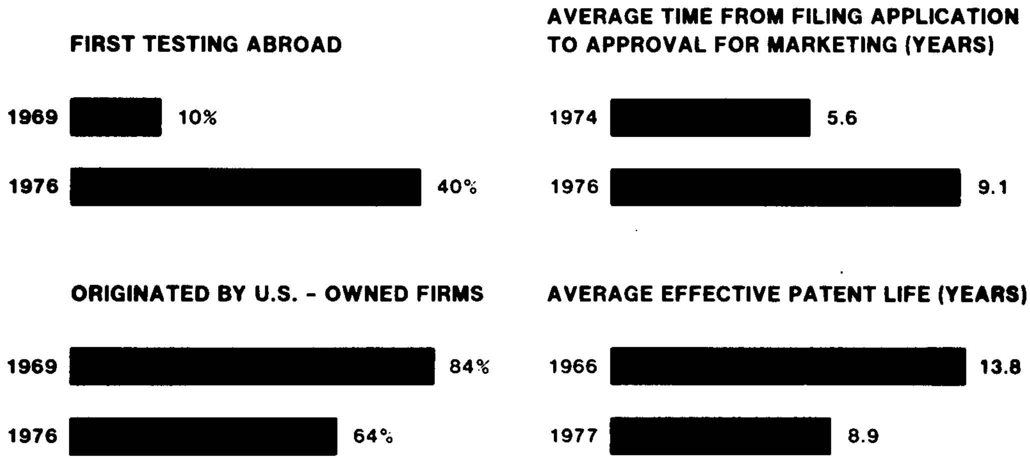
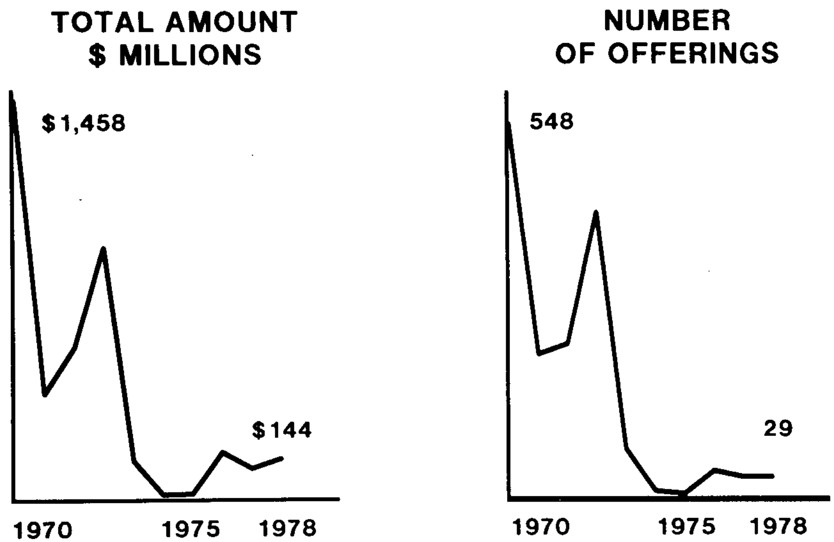


CHART 56

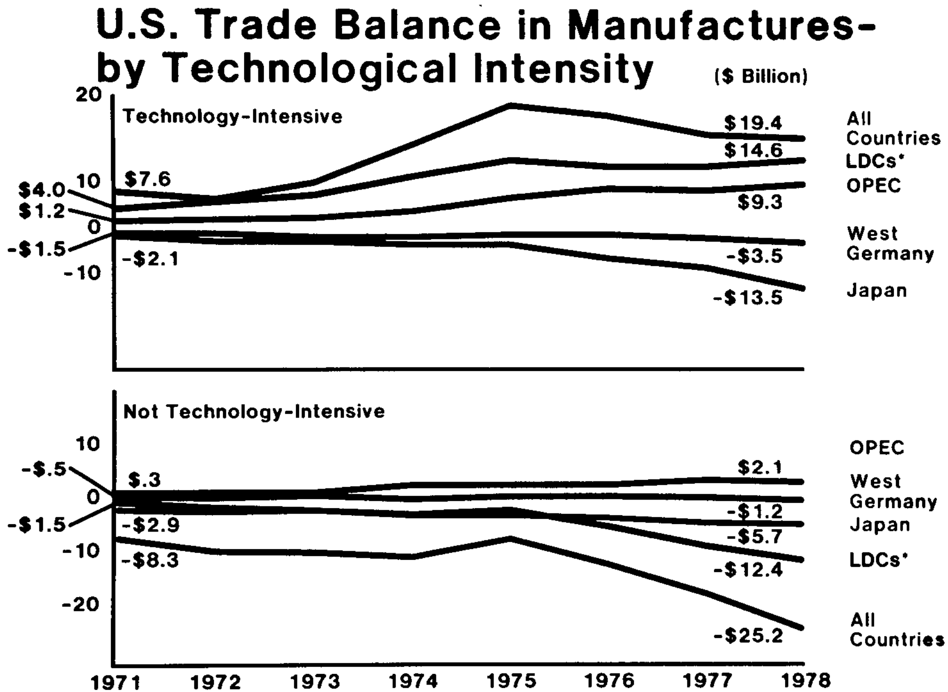
ABILITY OF SMALL FIRMS TO RAISE CAPITAL*



* Public Stock Offerings for Companies with Less than $5 Million Net Worth

Another technology/innovation measure is trade in technologically intensive products. I know there are all kinds of definitional problems on what we mean by technologically intensive products. Overall, we have still been doing well in these areas. However, vis-a-vis Japan and West Germany [Chart 57] -- and I am sure all of us who run companies like to look at our toughest competitors, particularly if we are trying to predict the future -- you can see that there has been a significant erosion. Our trade in technologically intensive products with Japan reached a $13.5 billion deficit in 1978. The recent and most interesting study on international competitiveness submitted to the Congress now indicates that Japan has the largest trade surplus in technologically intensive products of any country in the world.

CHART 57



*Includes nine non-OPEC LDCs, Australia and New Zealand

A Disappointing Trade and Export Performance

What is happening more generally to our share of world exports? [Chart 61] I am indebted to Fred Bergsten for some material he showed me that suggests that we should do some adjusting of dollars based upon changes in exchange rates. But I think Fred would indicate that he too is concerned about our share of world exports, especially in the manufactured area. Let us look here at two or three checkpoints. In 1970 you will notice [Chart 63] that we and the West Germans were roughly at the same level in terms of exports of manufactures. Only 8 years later you can see that Germany exported $31 billion more than we in manufactures. In 1970 the Japanese were 35% behind us, but by 1978 they matched our dollar level.

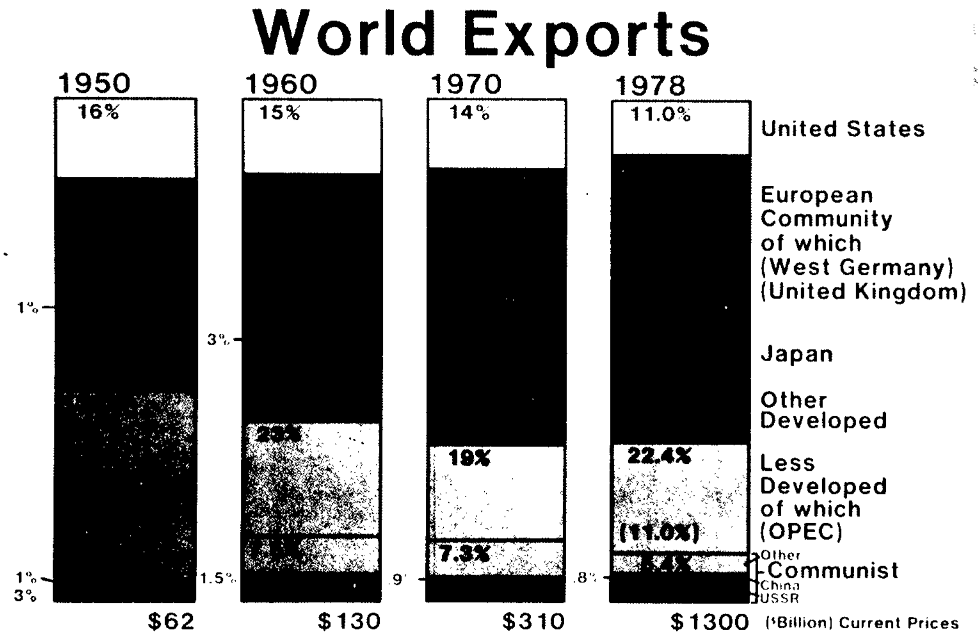
What has happened, of course, is a significant erosion in our trade share of manufactures, at least in dollar terms. [Chart 64] The competitiveness study that I referred to earlier indicated that in 17 major manufacturing categories the U.S. had increased its market share in none of them, while Japan and West Germany had increased their market share in 14 of the 17 major categories. While we are talking here principally about manufactured goods, I think the point Jack Harbin of Halliburton made last night to a group of us is one that should be respected: namely, that there also is something significant going on in the contracting, service business, where we have traditionally had large surpluses. For example, the recent McGraw-Hill study of shares of the engineering contracts in the Middle East indicates the U.S. share has now fallen precipitously to something like 1.6%. Of course, some recent laws are having a significant effect.

It has become very popular to either suggest that all of us industrialized countries are in this hopeless situation together, or that this country has a patent on the problem of imported-oil deficits. Thus, I thought it would be interesting to take the 1970-1978 trade numbers for the U.S., Japan, and West Germany and break them down by fuels, foodstuffs, raw materials, and manufactured goods. [Chart 68] Let us take the Japanese case because it is in some ways the clearest illustration of both the problem and the response. You will notice on fuels (remember that Japan imports 99 1/2% of their oil) that it too experienced a dramatic increase in its fuel deficit of over $27 billion between 1970 and 1978. This is nearly equal to our increased fuel deficit, but of course Japan has a much smaller economy than ours. You will notice that Japan has also experienced an increase in its food deficit of roughly $8 or $9 billion. It has experienced an equivalent increase in its raw materials deficit over that period of time. And if you add up all three, you will come up with something like $46 billion of increased deficits for Japan in fuels, food, and other raw materials.

The United States possesses far more domestic minerals and other resources and has enjoyed a dramatic increase of about $12 billion in our agricultural surpluses. Thus, the U.S. had an increased deficit in these three categories on the order of 60% of Japan's number, 25 to 30 billion dollars, on a much larger economy. Put another way, the total increase in the U.S. trade deficit in fuel, food, and resources is equal to the increase in Japan's fuel deficit alone.

How, then, does Japan still manage a large overall trade surplus in spite of nearly $50 billion dollars in these three areas? Well, you can see what has happened in the manufactures sector. From 1970 to 1978 the Japanese increased their manufactured goods surplus from $12 1/2 billion to an astonishing $76 1/2

CHART 61



Exports within the six nation European Community accounted for 31% of total EC exports in 1950, 35% in 1960, 48% in 1970, 52% in 1978 (nine nation European Community).
In 1978, Soviet exports to Communist countries accounted for 60% of total exports.

CHART 63

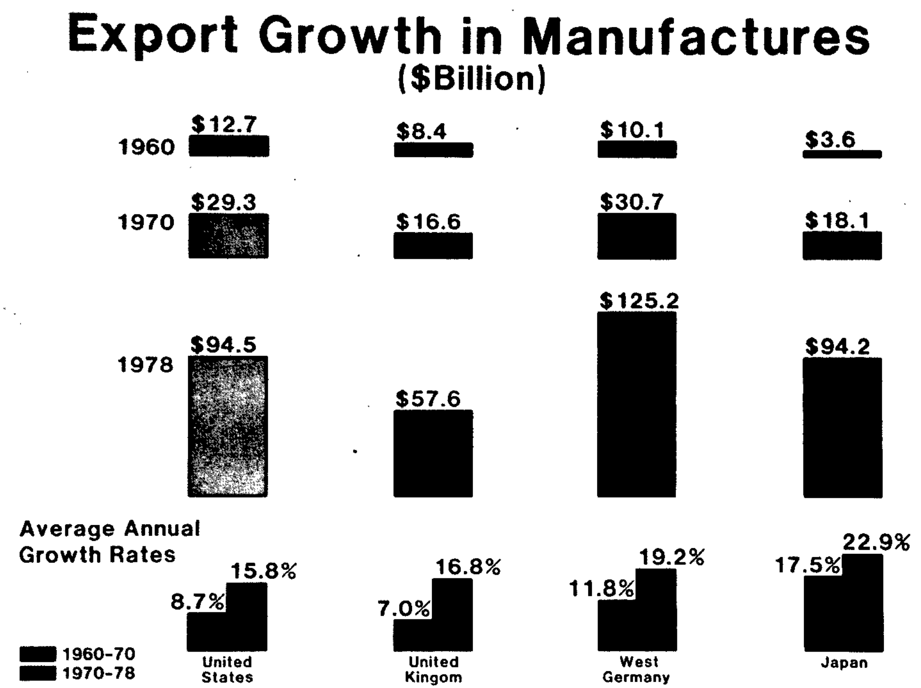
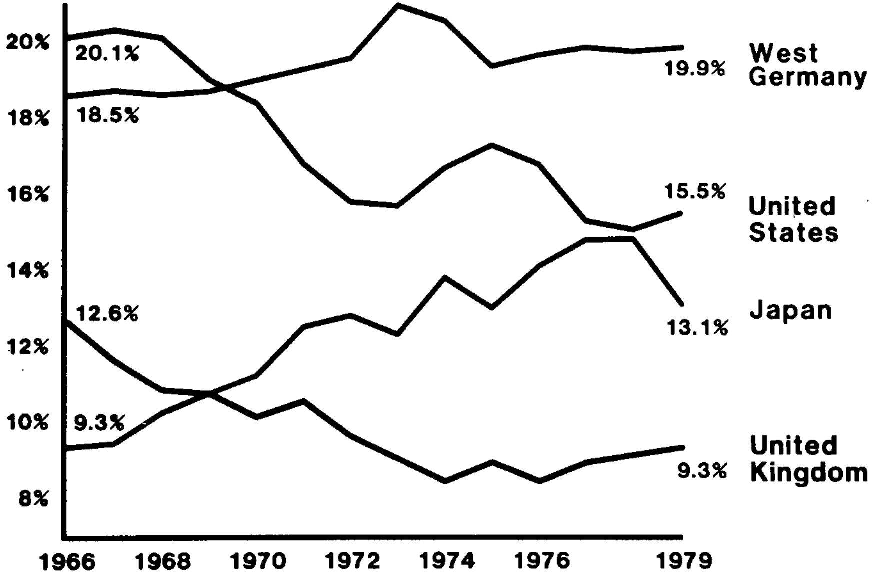

Export Growth in Manufactures
($Billion)
1960
1970
1978
$12.7
$29.3
$94.5
$8.4
$16.6
$57.6
$10.1
$30.7
$125.2
$3.6
$18.1
$94.2
Average Annual
Growth Rates
8.7%
15.8%
7.0%
16.8%
11.8%
19.2%
17.5%
22.9%
1960-70
1970-78
United States
United Kingom
West Germany
Japan

CHART 64

Share of Exports of Manufactures of the 14 Major Industrial Countries*

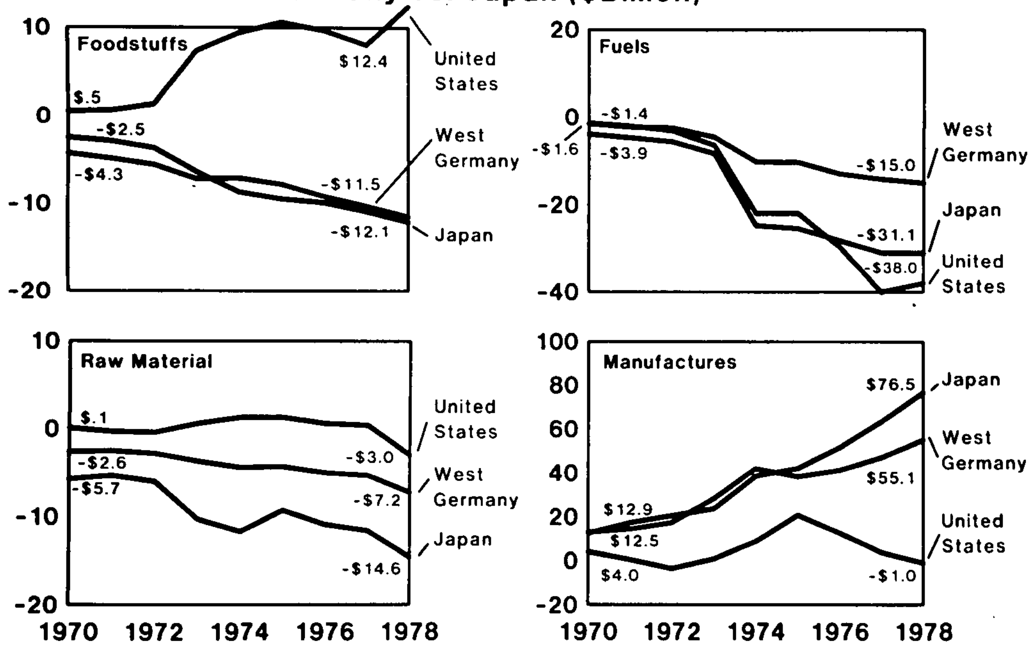


* These nations account for 80% of world exports of manufactures

81-489 0 - 81 - 5

CHART 68

Foreign Trade Balance - By Sector
US vs. West Germany vs. Japan ($Billion)

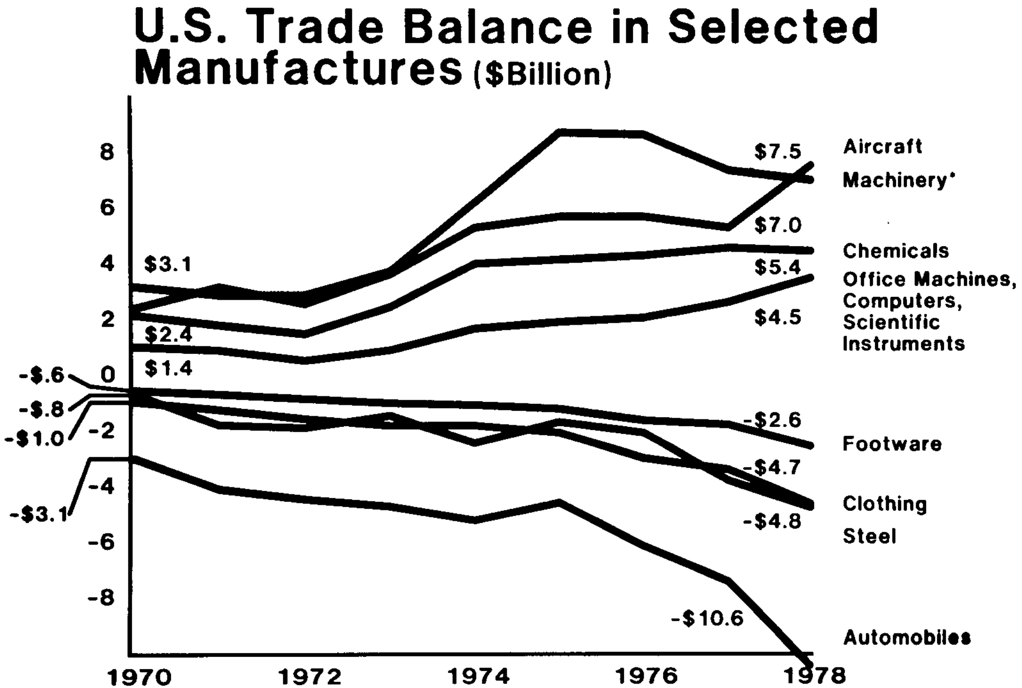


billion. This represents their more effective response to much more serious fuel, food, and resources problems than our own response.

We can compare trade outlooks for the future in terms of export trends by product lines. Here is the U.S. picture [Chart 69] -- not too many exciting growth areas up to now. The Japanese picture suggests, of course, a more positive portfolio of product trends. [Chart 70]

Other ways in which our competitors, "partners" I guess would be more charming, have responded to some of these export opportunities is to trade more with the Soviet Union. Some of us Americans were surprised that our Western Allies were something less than thrilled at the suggestion of a trade embargo with the Soviet Union. We might have been less surprised if we had been aware of the facts on chart 72 -- that in 1978 other OECD countries did about $54 billion of trade in that part of the world versus our $5 billion, or over 10 times as much trade as we.

CHART 69



* Agricultural, Electrical and Heavy Industrial

CHART 70

JAPAN'S TRADE BALANCE IN CERTAIN PRODUCTS

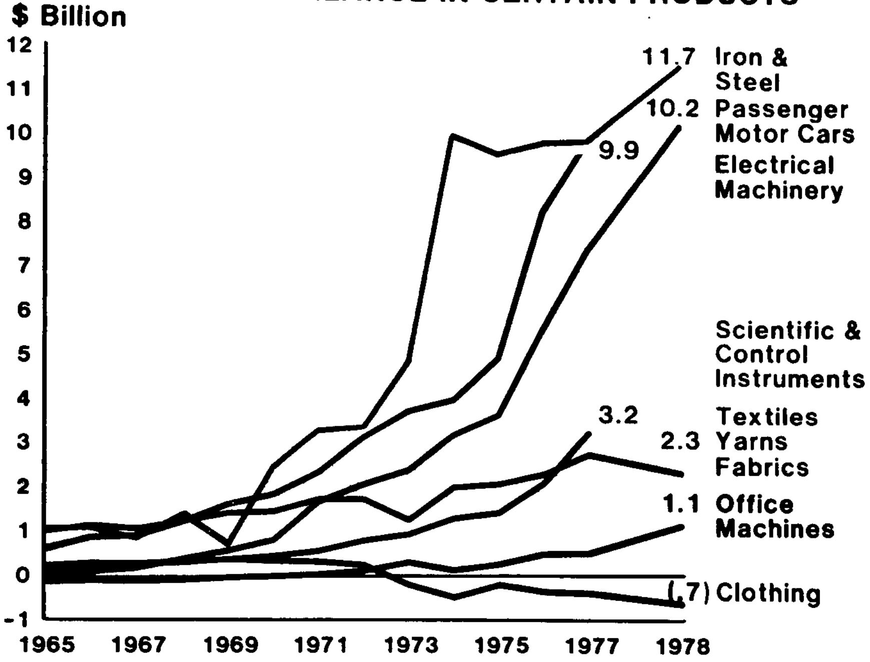
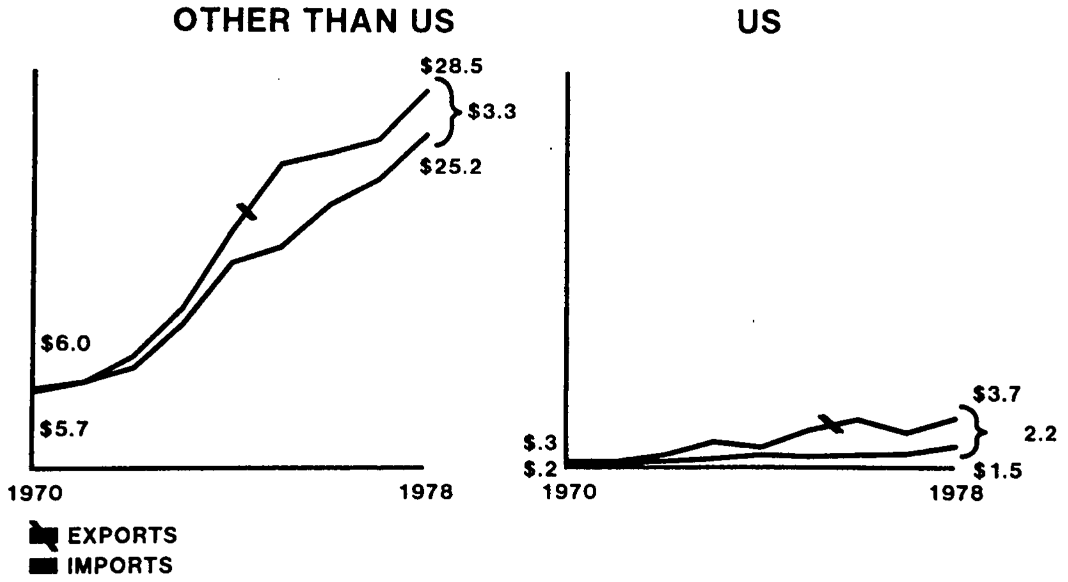


Chart 72

OECD TRADE WITH USSR AND EASTERN EUROPE ($ BILLION)



Developing Countries -- Big Opportunities and Big Problems

Another remarkable trade development has been the trade development of LDC's. These countries now account, as you can see in Chart 73, for more of our exports than the European community and Japan combined. Many of our companies know (but a surprising number do not) that the LDC's now account for 35, 40, 50, 55, 60% of certain very major categories of products. [Chart 74]

A problem that we will not have much time for today is one that I think has to move closer to the heart of the agenda of any group like The Center for International Business. This is the really striking increase in debt that is projected among the oil importing, developing countries, as estimated on Chart 80. There are several "solutions" to this problem. One of them of course is for these countries to reduce their imports by an equivalent amount. I remind you, however, that we are really in an interdependent world and all of the increase in exports of manufactured goods from all of the OECD countries since 1974 can be accounted for by increases to developing countries; one man's imports are another man's exports. Yet we are confronted with the problem that the commercial banking system, in my view, is unlikely to take up all of this slack. And until some multilateral help is offered in magnitudes not now forthcoming -- not even, in some ways, foreseeable -- companies in the multinational business are going to have to develop sophisticated expertise on this debt subject, country by country, whether they wish to or not.

CHART 73

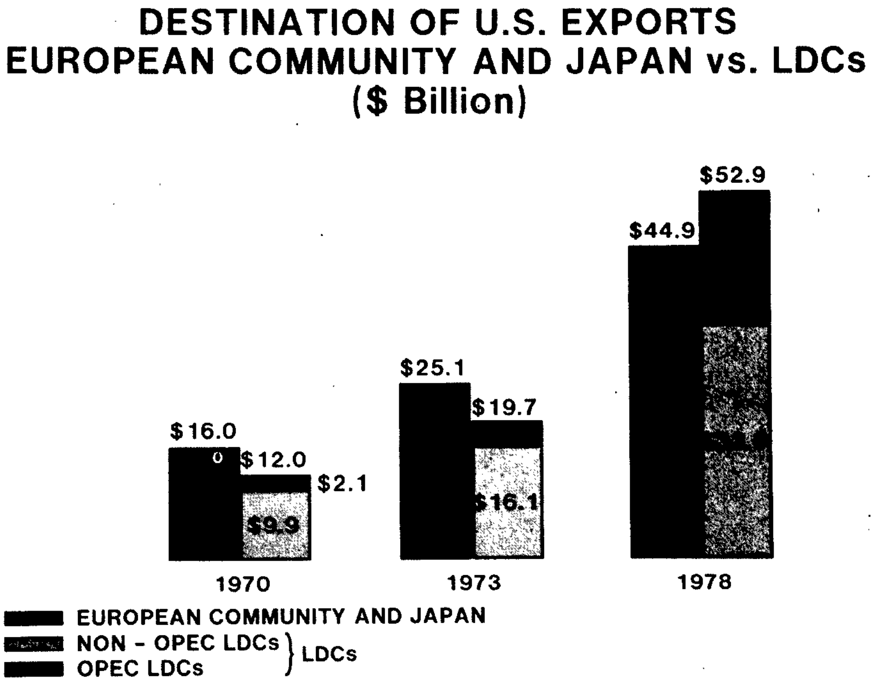

DESTINATION OF U.S. EXPORTS
EUROPEAN COMMUNITY AND JAPAN vs. LDCs
($ Billion)
$52.9
$44.9
$25.1
$19.7
$16.0
$12.0
$2.1
$9.9
$16.1
1970
1973
1978
EUROPEAN COMMUNITY AND JAPAN
NON - OPEC LDCs
OPEC LDCs
LDCs

CHART 74

LDC* SHARE OF U.S. EXPORTS

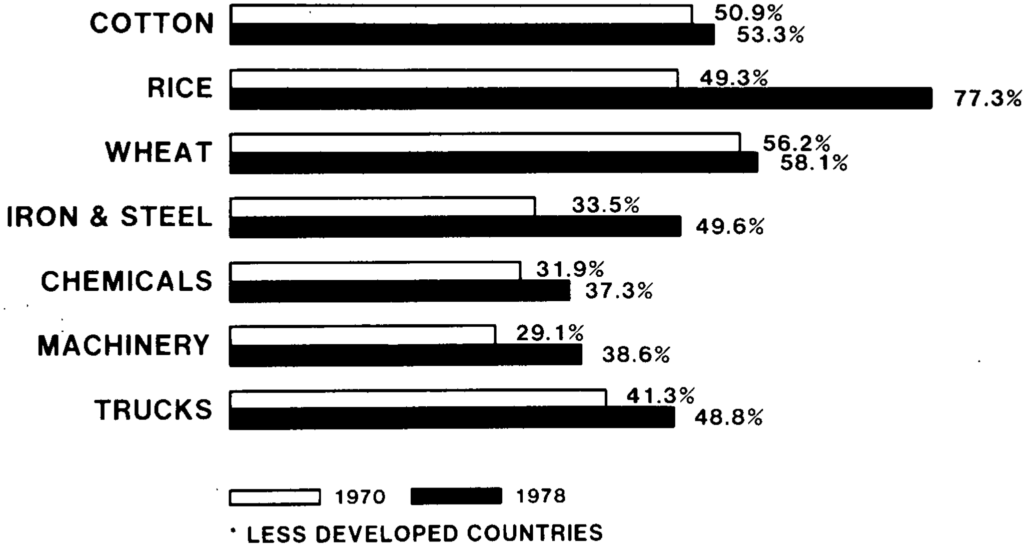
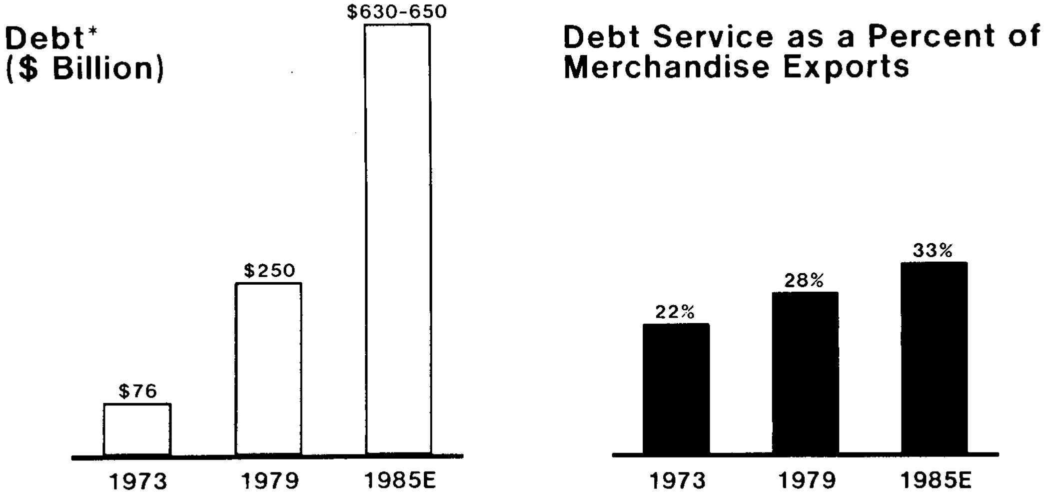


CHART 80

Non-Oil LDC Debt And Debt Service



* AT END OF YEAR; PUBLIC AND PUBLICALLY GUARANTEED DEBT; DOES NOT INCLUDE NON-GUARANTEED DEBT

Energy--

Let's move to the subject of energy -- and I am really preaching to the choir in Texas to talk about it. I am impressed, as I think of our energy supply alternatives, that in spite of all our efforts at phased deregulation, the Exxon Company still projects that by 1985 the nearly 10 million barrels per day of oil we now produce domestically will decline by 2 million barrels, to roughly 8 million barrels. [Chart 93] This will come at a time of increasing dependence on, and supply vulnerability to, certain OPEC countries. [Chart 97]

I am going to discuss briefly one aspect of the energy problem which is not a popular subject in this country, but which I think should be. In terms of population, GNP, oil consumption, and gasoline consumption, [Chart 83] you will see that the U.S., with 5% of the people, somehow manages to consume 49% of the world's gasoline. We wonder why the rest of the world at times suggests we are being a bit profligate; they often use more pejorative phrases than that. They wonder about our conviction to contribute to a balancing of supply and demand of oil when they see [Chart 88] that they are charging about $1.25 to $1.75 in gasoline taxes while we are still charging 14 cents, and even the vast majority of that small tax goes to the highway trust fund, which of course is still more "reassuring" to our allies across the world.

This is happening in spite of the well-known fact that we have extraordinary reserves of coal and nuclear. Yet we are now in the interesting position where oil accounts for 3 1/2% of our reserves, but a striking 49% of our consumption. [Chart 94] Sooner or later the inevitable balancing will take place; the only question on coal and nuclear remains: When? How long will it take?

CHART 93

DECLINING U.S. OIL PRODUCTION
(Million Barrels Per Day)

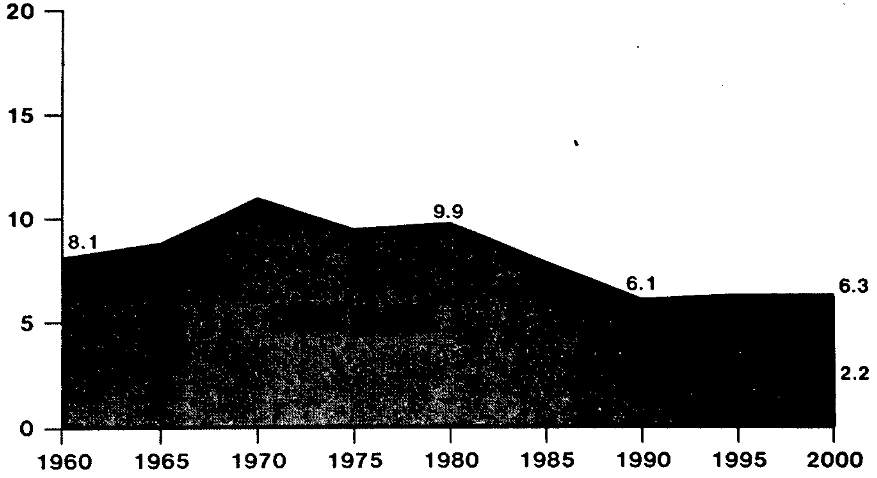


CHART 97

PROPORTION OF IMPORTED OIL COMING FROM THE PERSIAN GULF (1979)

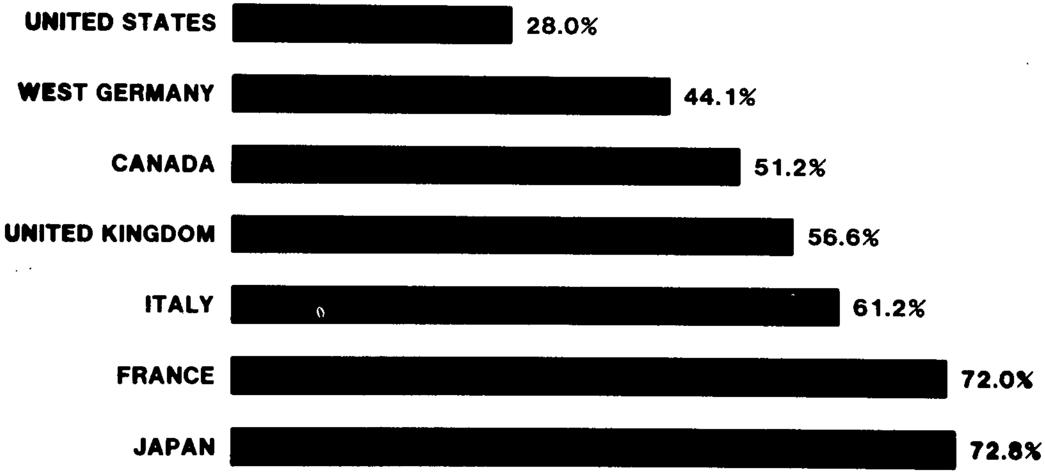
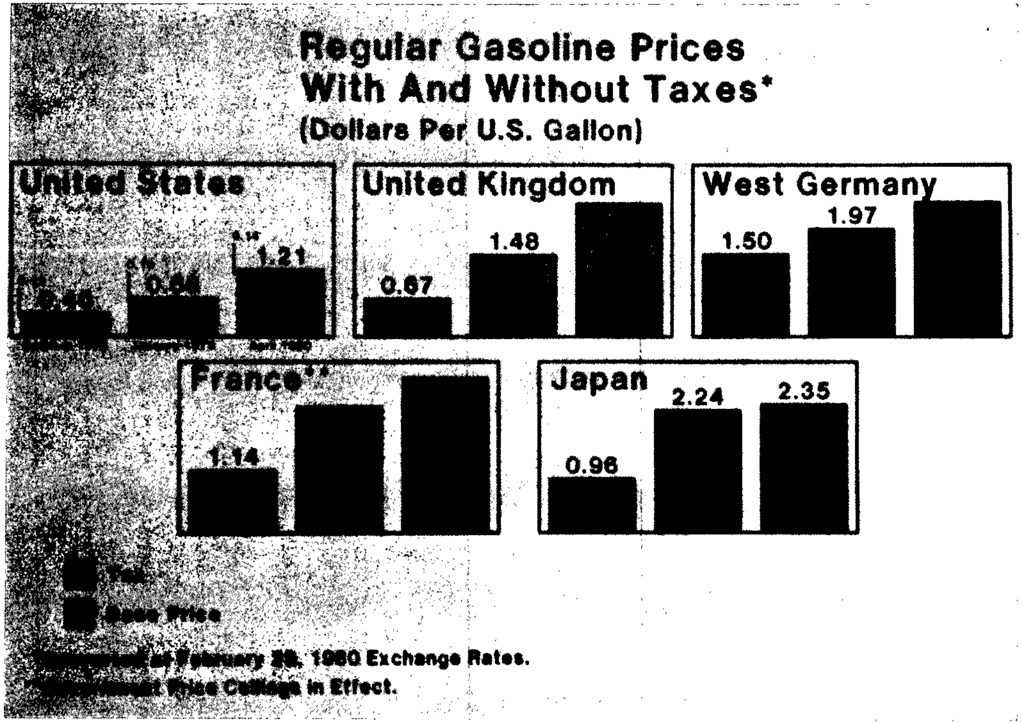


CHART 83

POPULATION, GNP AND ENERGY USE

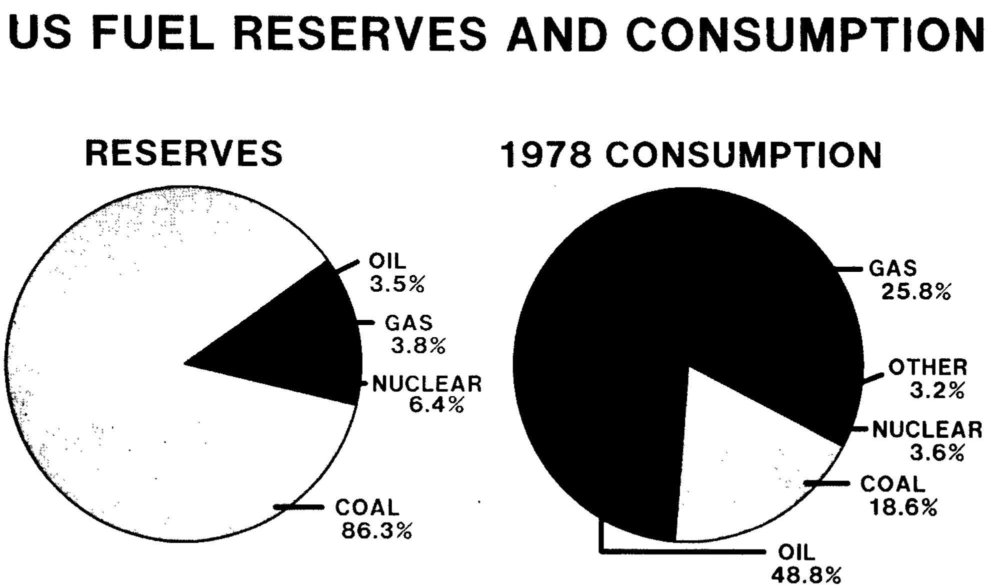
	POPULATION	SHARE OF WORLD GNP	SHARE OF OIL CONSUMPTION	SHARE OF GASOLINE CONSUMPTION
UNITED KINGDOM	1.4%	3.2%	3.0%	2.6%
WEST GERMANY	1.5	6.6	4.8	3.5
JAPAN	2.8	10.0	8.2	3.7
UNITED STATES	5.3	21.8	30.2	49.3

CHART 88


Regular Gasoline Prices
With And Without Taxes*
(Dollars Per U.S. Gallon)
United States
1.21
United Kingdom
0.67
1.48
West Germany
1.50
1.97
France**
1.14
Japan
0.96
2.24
2.35
1980 Exchange Rates.
in Effect.

74

CHART 94


US FUEL RESERVES AND CONSUMPTION
RESERVES
OIL 3.5%
GAS 3.8%
NUCLEAR 6.4%
COAL 86.3%
1978 CONSUMPTION
GAS 25.8%
OTHER 3.2%
NUCLEAR 3.6%
COAL 18.6%
OIL 48.8%

U.S. Soviet Defense Balances -- Another Declining Trend

I do not think any quick review by the keynote speaker of this conference on the world economic and political situation can ignore a disturbing fact. It is particularly disturbing to me because I was among those in the U.S. Government in 1972 responsible for negotiating commercial matters with the Soviet Union. Since then I have been trying to figure out what has happened on the defense expenditure front. Currently we are putting significantly less (almost 3% less of our GNP) into support of the Western system, defense and aid, than in 1970. [Chart 99] Our allies are moving up much closer to our level, with the exception of Japan, which is still under 1%.

But what about the Soviet Union? I asked a new colleague in our firm, Jim Schlesinger, to take all of these official statistical extrapolations [Chart 100] involving rubles and translate them in terms of amounts of various kinds of military equipment that the Soviet Union and the U.S. have [Chart 101] -- such as tanks, armored vehicles, helicopters, and the like. What is striking to me is that from 1974 through 1979 -- and certainly in 1979 -- in most categories there are really very substantial differences in the current production rates. [Chart 102] And, as with plant and equipment, this obviously means that much Soviet military equipment is considerably newer than ours.

It is unfortunate that a productivity crisis and an energy crisis are now compounded by a defense crisis, but these are the realities with which we must also deal.

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CHART 99

Support for Western System

(Share of GNP)

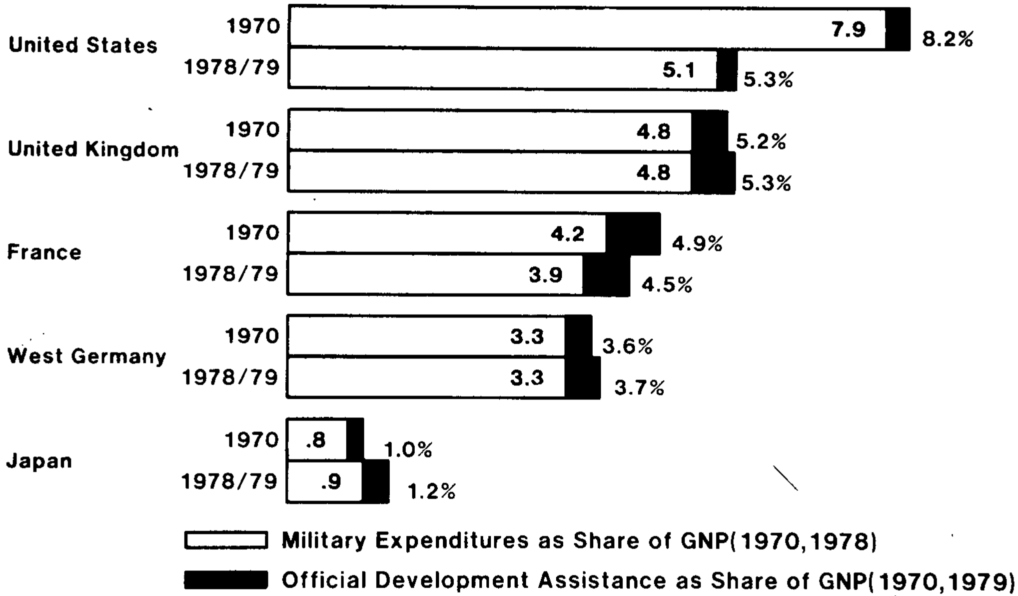
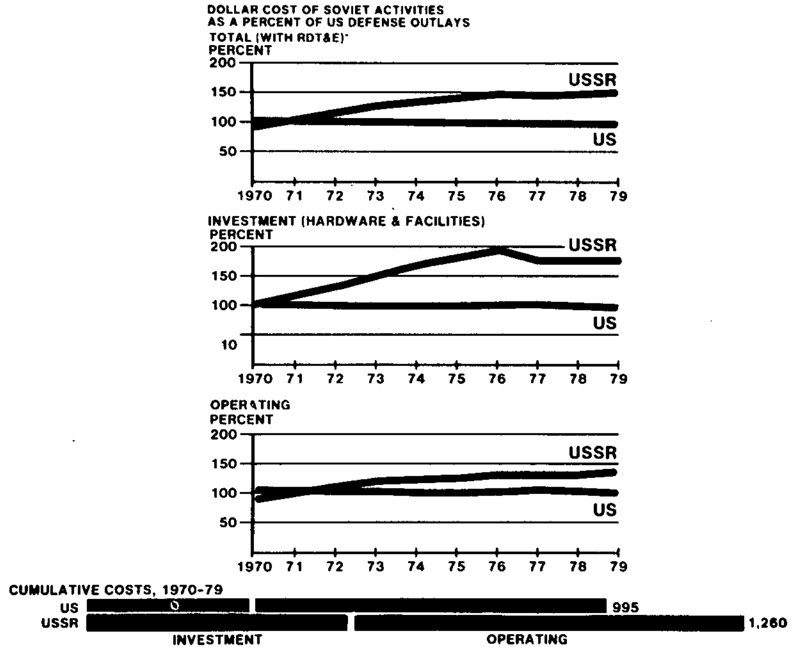


Chart 100

US AND SOVIET UNION DEFENSE ACTIVITIES



INVESTMENT INCLUDES ALL COSTS FOR THE PROCUREMENT OF MILITARY HARDWARE AND THE CONSTRUCTION OF FACILITIES, BUT EXCLUDES RDT&E. OPERATING INCLUDES ALL PERSONNEL-RELATED COSTS (WITH THE EXCEPTION OF PENSIONS) AND ALL COSTS ASSOCIATED WITH THE OPERATION AND MAINTENANCE OF WEAPON SYSTEMS AND FACILITIES.

*RTD&E = RESEARCH, DEVELOPMENT, TESTING & EVALUATION

CHART 101

Key Measures of U.S. - Soviet Military Balance

Category	U.S.	Soviet
Strategic		
ICBMs	1054	1400
SLBMs	656	950
Heavy Bombers (including Backfire)	316 (excludes mothballs & variants)	215 (includes 90 Backfire, excludes variants)
Ballistic Missile Submarines	41	90
total throwweight	7.8 m. lbs.	14.7 m. lbs.
total megatonnage	2887 mt.	8352 mt.
total warheads	8526	6132
Interceptors	309	3200
SAMs	36	10000
Ground Forces		
Divisions	19	169
Tanks	10570	53000
Artillery	17500	40700
Air Forces		
Medium Bombers	66	761
Fighter & attack aircraft	3400	4690
Air defense radars	59	7000
Transports	936	1305
Naval Forces		
Active Fleet	398	954
Carriers	12	3
Naval & marine aircraft	1464	1310
Attack submarines	77	270

CHART 102

PRODUCTION RATES FOR UNITED STATES AND U.S.S.R.

	1974 - 78 (Annual Average)		1979	
	U.S.	U.S.S.R.	U.S.	U.S.S.R.
Tanks	800	1800	850	2500
Armored Vehicles (APCS. Light Tanks. IFC/S etc.)	375	3800	1250	4000
Tactical Fighters/Bombers	275	650	350	650
Helicopters	315	1000	250	700
Major Surface Combatants	5	10	8	7
Attack Submarines	2.5	5	2	7
Missile Submarines	0	6	0	2
Strategic Intercepters	0	200	0	175
Surface-to-Air Missiles*	3600	24,000	4200	28,000
Artillery (Rocket Launchers Over 100 MM)	20	1600	75	1250

* Figures show total production. incl. exports

What Have We Been Doing With Our Resources?

We have not been putting our resources in research. We have not been putting them in plant and equipment. We have not been putting them in defense. The obvious question is: what have we been doing with our resources? To put this in perspective, we have to go back a number of years.

34% of our GNP is now appropriated by the government sector. [Chart 103] You can also see [Chart 105] the striking increase in only 30 years in the federal sector's share of the GNP.

This is partially due to our most interesting tax system [Chart 106] that I am sure would delight Mr. Parkinson, whose famous book suggests that we are endlessly ingenious in filling given amounts of space or spending given amounts of money. I looked at a study of what happens to income taxes paid at income levels of $10,000, $25,000, $50,000 and $75,000 if a couple's income goes up 10%. You will see in every case that their taxes go up much faster, up 15% to 17% compared to the 10% rise in their income. So, we have an interesting tax system in this country which is the delight of those who like to spend money; in which tax revenues from individuals are going up about 60% faster than individual incomes. Unless something is done, increasing amounts of GNP will be inexorably spent at federal levels -- some say it could be 24%-25% of GNP by 1985. To bring all this down to the median family: in 1965, its federal tax rate was 9.3%; in 1980, it hit 17.6%.

We are endlessly ingenious both in corporations and in government in handling strained balance sheets. Notice that in 1976, 1978, and 1980 the real deficits are dramatically larger than what we have been led to believe. We talked glibly about balancing budgets in 1980. We talked glibly a few years ago of tax cuts, post-Vietnam "peace" dividends, and the like. Thus, not only have we had very large published deficits, but the red columns [Chart 107] -- I think they are appropriately colored -- will illustrate the dramatic increase in off-budget deficits in fiscal 1980 hit something like $17 billion.

Vast Government Deficits Equal Vast Government Borrowing

Now all that, of course, gives rise to extraordinary increases in government borrowing -- about 13% annual compounded growth from 1974 - 1979. [Chart 109] You can see here that in a period of only 30 years through every kind of administration the share of the total credit borrowings undertaken by the federal government has moved dramatically from 5% to 23%, obviously taking funds that could have been available for the private sector. [Chart 110]

CHART 103

GROWTH OF GOVERNMENT EXPENDITURES IN THE UNITED STATES -- ALL LEVELS OF GOVERNMENT

EXPENDITURES

	TOTAL GOVERNMENT ($ BILLIONS)	PER CAPITA (1958 DOLLARS)	PERCENT OF GNP
1890	0.8	45	6.5
1902	1.5	58	7.3
1913	3.2	89	7.8
1922	9.3	163	12.6
1929	10.3	143	10.0
1940	18.4	288	18.4
1950	61.0	484	21.3
1960	136.4	740	27.0
1970	311.9	1,138	31.8
1980	839.0	1,332	34.0

CHART 105

U.S. Federal Sector Expenditures As Share of GNP (Average)

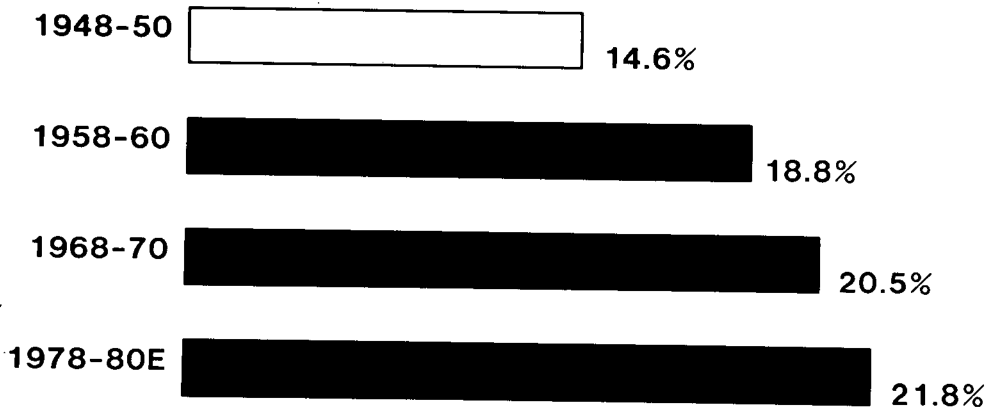


CHART 106

INCREASE IN FEDERAL PERSONAL INCOME TAXES WITH 10% INCREASE IN TAXABLE INCOME

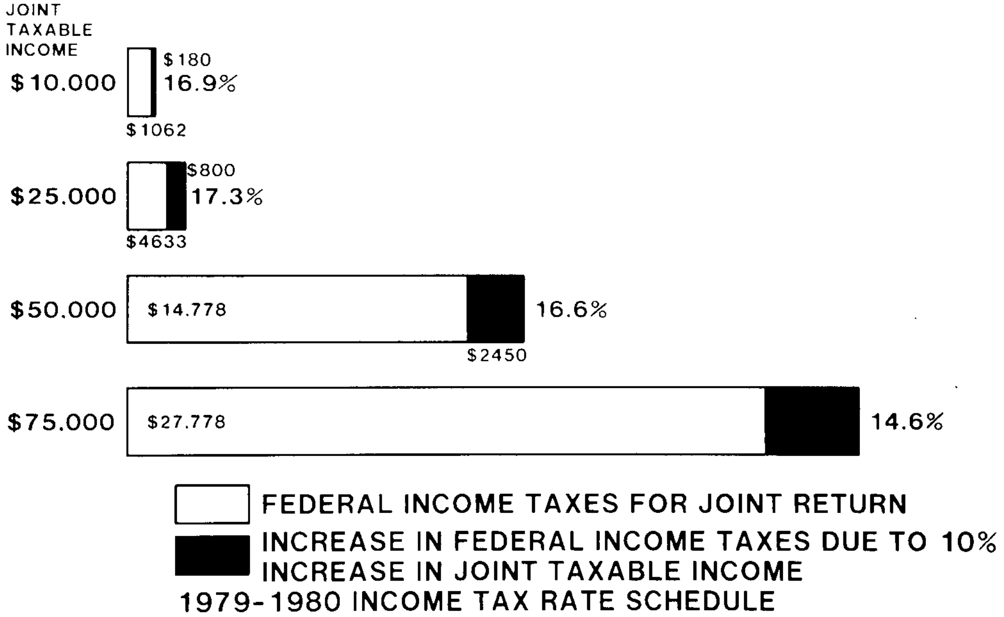


Chart 107

EFFECT OF GROWTH OF OFF-BUDGET FEDERAL ENTITIES ON FEDERAL BUDGET DEFICIT

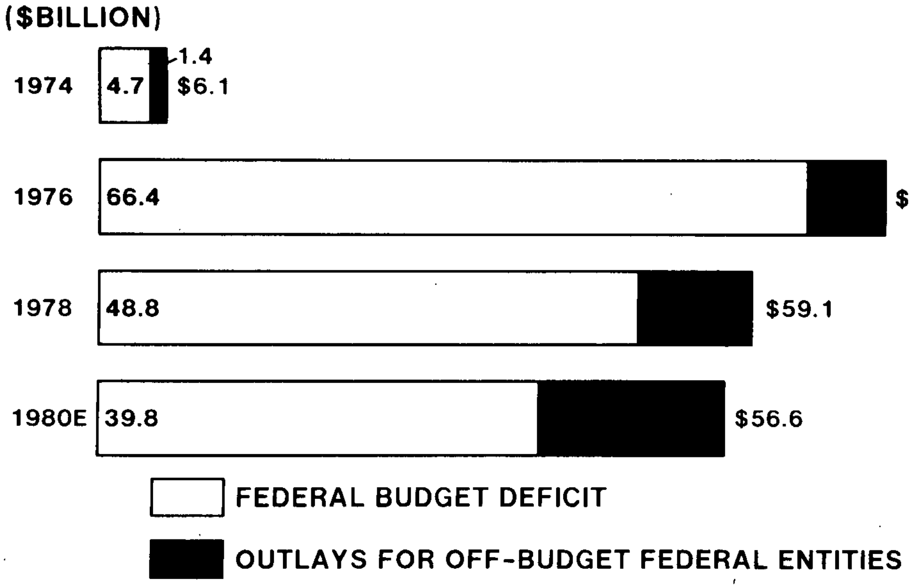
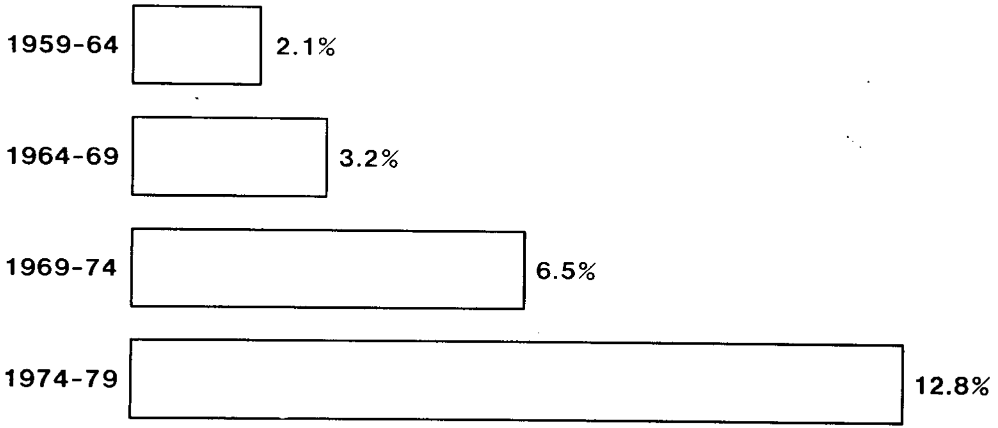


CHART 109

GROWTH IN BORROWINGS BY U.S. TREASURY AND FEDERALLY SPONSORED AGENCIES

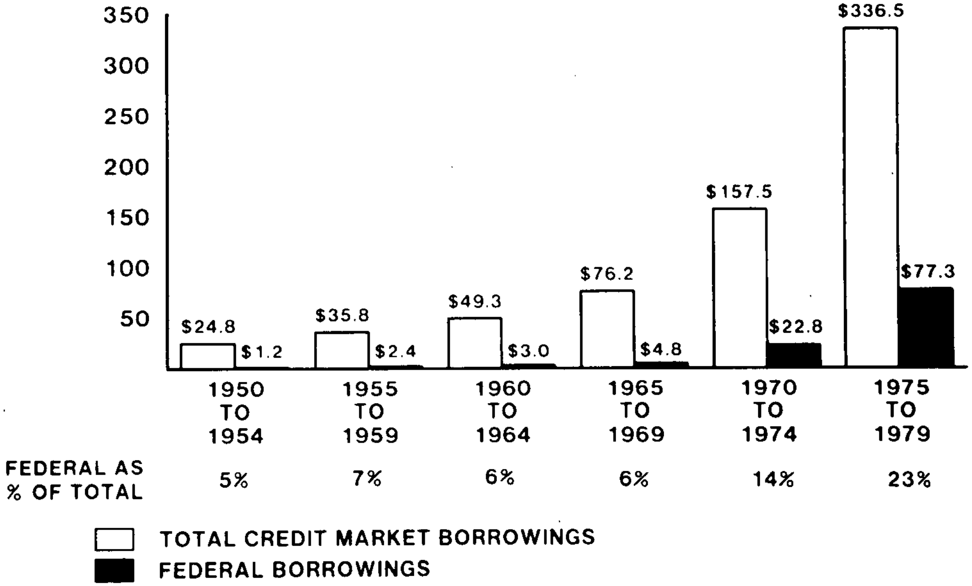
(YEAREND OUTSTANDINGS; ANNUAL AVERAGE GROWTH RATE)



*FEDERALLY SPONSORED AGENCIES INCLUDE: FEDERAL NATIONAL MORTGAGE ASSOCIATION, FEDERAL HOME LOAN BOARD, FEDERAL HOME LOAN MORTGAGE CORPORATION, FEDERAL LAND BANKS, FEDERAL INTERMEDIATE CREDIT BANK, AND BANKS FOR COOPERATIVES.

CHART 110

FEDERAL GOVERNMENT BORROWINGS
vs.
TOTAL CREDIT BORROWINGS



Much Less in Defense -- Much More on Human Resources

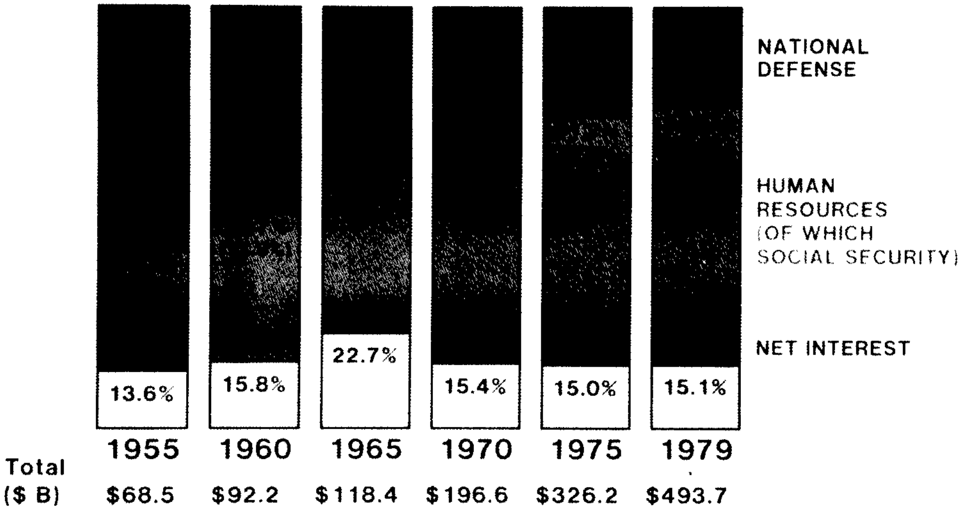
Now, what have we been doing with these resources? This chart illustrates the dramatic shrinkage in only 25 years in the percentage going to national defense and the equally dramatic increase going to human resources. [Chart 112] There also has been a significant change from purchasing goods and services to transfer payments to individuals [Chart 113] which in the year 1980 hit the interesting number of $267 billion and is growing rapidly.

The growth in other than human resource programs over the 1970-1980 period is about 115%; but the growth in human resource programs is over 300%. [Chart 115] You can see for yourself in Chart 116 this list of specific transfer payment programs. I am not displaying this either to bore or depress you. Rather, it occurred to me that you may have had the same problem that I have had with this issue; I read about these programs in general but I have trouble gaining a specific understanding of them. There is, though, a common pattern here. The programs start out small when special interest groups argue with great conviction that these programs are necessary. Then, five years later, with the costs having ballooned, a different argument is used: namely, that the political expectation of support is now so embedded that it would seem almost unconstitutional to cut back the program. Finally we make the melancholy observation that 75% of our Federal budget is "uncontrollable." [Chart 114]

CHART 112

FEDERAL BUDGET FOCUS - FROM NATIONAL DEFENSE TO HUMAN RESOURCES

(Fiscal Year)



'Includes, among others, Transportation, Community and Regional Development, and National Resources and Environment

Chart 113

FEDERAL GOVERNMENT - FROM DIRECT PURCHASER TO TRANSFER AGENT

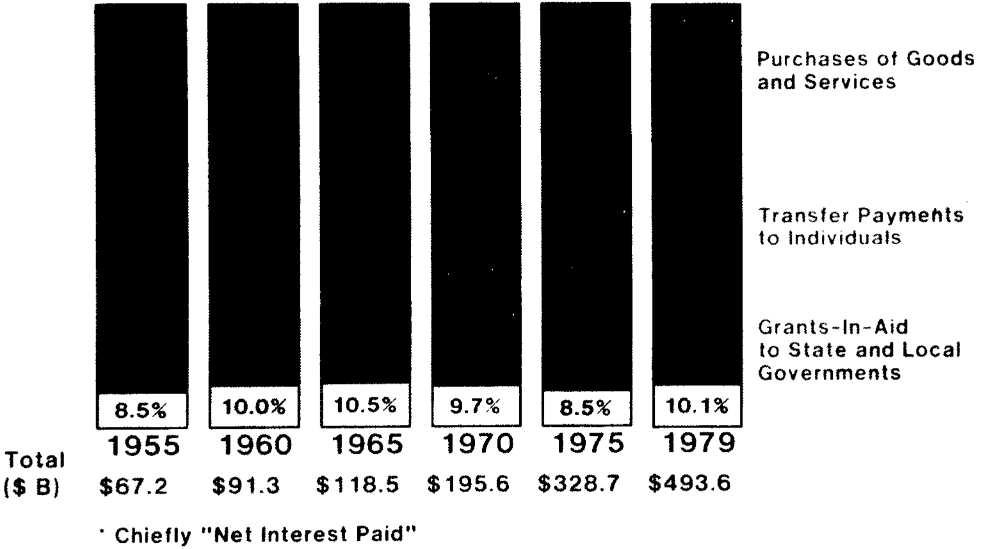
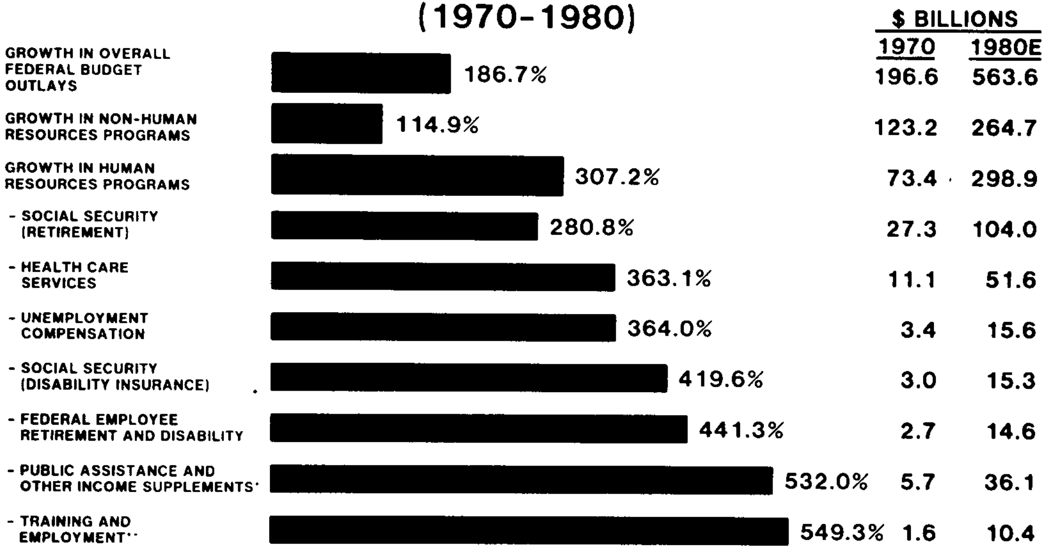


Chart 115

GROWTH IN HUMAN RESOURCES PROGRAMS

(1970-1980)

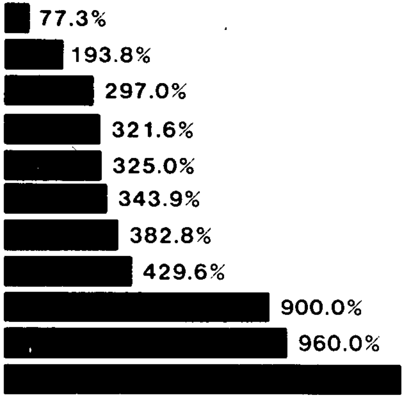


*CHIEFLY FOOD STAMPS, AID TO FAMILIES WITH DEPENDENT CHILDREN, SUPPLEMENTAL SECURITY INCOME AND HOUSING ASSISTANCE

**CHIEFLY CETA PROGRAMS (INCLUDING PUBLIC SERVICE EMPLOYMENT, GENERAL TRAINING AND EMPLOYMENT PROGRAMS, AND YOUTH PROGRAMS)

CHART 116

GROWTH IN US TRANSFER PAYMENT PROGRAMS (1970-1980)



	Growth	$ BILLIONS 1970	$ BILLIONS 1980E
VETERANS BENEFITS	77.3%	6.6	11.7
RAILROAD RETIREMENT	193.8%	1.6	4.7
SOCIAL SECURITY	297.0%	29.7	117.9
UNEMPLOYMENT INSURANCE	321.6%	3.7	15.6
MILITARY PENSIONS	325.0%	2.8	11.9
PUBLIC ASSISTANCE *	343.9%	4.1	18.2
MEDICAID & MEDICARE	382.8%	9.9	47.8
FEDERAL EMPLOYEE RETIREMENT	429.6%	2.7	14.3
SCHOOL LUNCH PROGRAM	900.0%	.4	4.0
HOUSING ASSISTANCE	960.0%	.5	5.3
FOOD STAMPS	1350.0%	.6	8.7
		63.2 **	266.9 **

* MAINLY WELFARE

** TOTAL INCLUDES $.6 (1970) AND $6.8 (1980E) NOT SPECIFICALLY SHOWN, OF WHICH $2.0 (1980E) IS FOR DISABLED MINERS' BENEFITS

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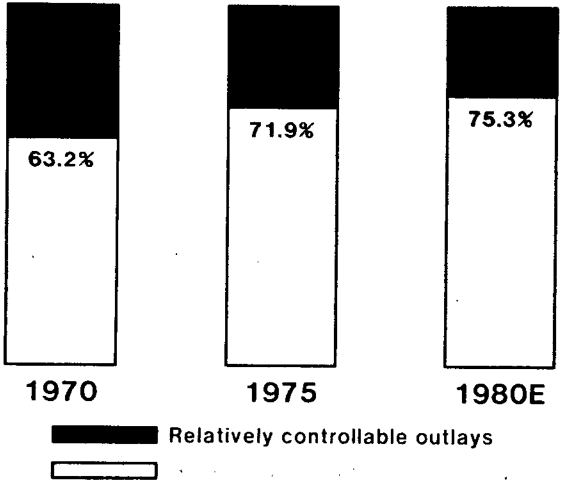
CHART 114

FEDERAL BUDGET – RELATIVELY UNCONTROLLABLE OUTLAYS*



*OPEN-ENDED PROGRAMS AND FIXED COSTS (INCLUDING SOCIAL SECURITY, MEDICAL CARE, UNEMPLOYMENT ASSISTANCE AND NET INTEREST)

Social Security -- The Inevitable and Painful Example

I do not think that any broad survey of our general economic situation can possibly avoid the question of social security. It is, as you saw, a very large part of our human resource, transfer payment expenditures. When I was brought up in my home state of Nebraska, I recall vividly forty years ago being told by my parents that this was a trust fund system. They believed that their money was being put away somewhere for their retirement, rather like a savings account. We can see that as recently as 1955 the asset/expenditure ratio was over 400%; in other words there were four years worth of assets in relation to the projected years expenditures. We are now down to less than 3 months and next year's prognosis is bleak. [Chart 117] You can also see the marked decline in contributors per beneficiary as the demographics of this country change dramatically toward more senior citizens. Partly to scare you and partly to point out that we can no longer avoid a constructive resolution of this social security situation, I reviewed some research to compare the net individual wealth of this country to their claims on the social security system. As you can see in Chart 118, the most recent study in 1977 suggests that the social security claims of individuals was something over $4 trillion, or about 76% of the aggregate net individual wealth, the total wealth held by individuals in this country.

The Urgent Need for Trade-Offs

So we must come to grips with some hard trade-offs, a painful prospect in our society. For too long we have thought that all of us could more or less have it all. Thus, to illustrate the tradeoffs, let us take this social security deficit and over a ten-year period say, "suppose we didn't have that deficit, what could we have done to increase R&D investment, what could we do to increase investment in plant and equipment?" If, somehow, we could do something about this deficit [Chart 121], that something would have a dramatic impact on releasing resources for these other purposes. We could, for example, roughly quadruple our R&D expenditures.

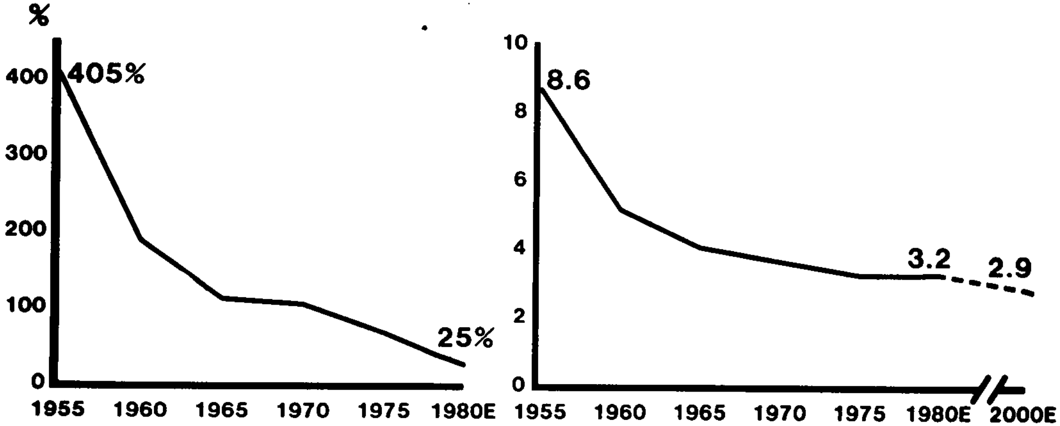
One can't be sure, but the current deficit of the social security retirement system -- not including disability -- is at least $650 billion and probably a $1 trillion dollars or more, depending upon how you want to make your inflation and demographic assumptions. These deficits have occurred in spite of the fact that the combined employer and employee tax rate has doubled since 1960 from 6% to over 12%.

Now, let us illustrate the effect that certain changes in benefits might have. If, for example, we increased the retirement age from 65 to 68 (over a period of time) or alternately, if we could contemplate -- if anyone can -- raising the payroll tax to over 20%, then we would erase that entire deficit. [Chart 120] These are the kinds of painful alternatives that we are going to have to start debating, particularly if we provide alternative ways for people to build their retirement income.

CHART 117

FINANCIAL ASPECTS OF THE SOCIAL SECURITY SYSTEM

FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY TRUST FUNDS (OASDI)



ASSETS AS PERCENTAGE OF EXPENDITURES*

*Assets at beginning of year
Expenditures during the year

CONTRIBUTORS PER BENEFICIARY

CHART 118

AGGREGATE SOCIAL SECURITY CLAIMS OF INDIVIDUALS VS. NET INDIVIDUAL WEALTH ($BILLION)

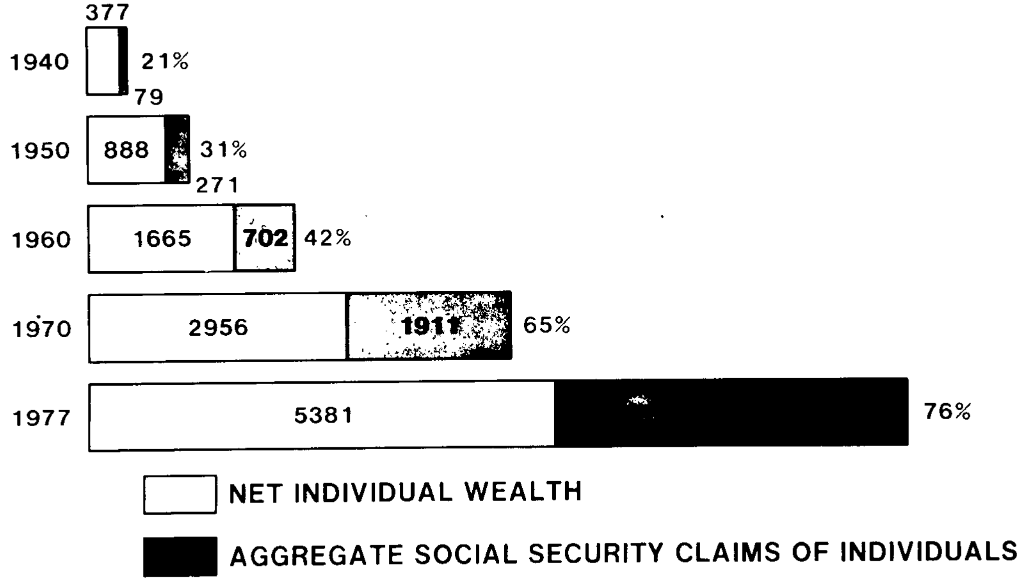
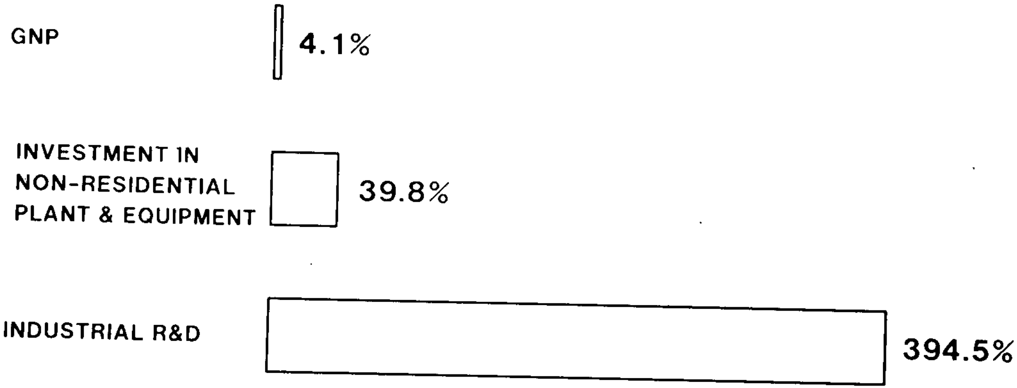


CHART 121

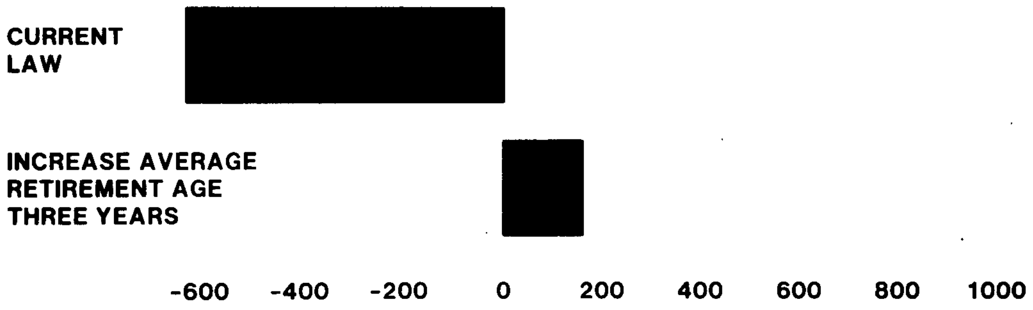
CURRENT SOCIAL SECURITY DEFICIT* IN RELATION TO GNP, INVESTMENT IN PLANT & EQUIPMENT INDUSTRIAL R&D (1970-79)



* ESTIMATED AT $632 BILLION FOR OLD-AGE AND SURVIVOR INSURANCE TRUST FUND (DISABILITY INSURANCE TRUST FUND NOT INCLUDED)

CHART 120

NET FINANCIAL STATUS OF THE SOCIAL SECURITY RETIREMENT SYSTEM*
($ BILLION)



*DOLLARS DISCOUNTED TO 1977, ADJUSTED FOR INFLATION; SSA INTERMEDIATE ASSUMPTIONS. RETIREMENT PORTIONS OF SOCIAL SECURITY ONLY, SIMILAR BUT SMALLER EFFECTS IN DISABILITY INSURANCE & HEALTH INSURANCE

Ballooning Regulatory Costs In an Adversarial Economy

While we have been spending all of this money explicitly on various federal programs, we have also absorbed not only the exploding government regulatory budget [Chart 122] but much larger regulatory "compliance" costs -- costs which are implicit but nonetheless real.

The staffing of our regulatory agencies during this decade shows nearly four-fold increase in staff [Chart 124] and a seven-fold increase in budget. According to the work that Murray Weidenbaum has been doing, for every dollar the government spends there are at least twenty dollars being spent by the private sector in compliance. These aggregate numbers are probably now in the range of $125 billion and even these huge numbers do not include regulatory agencies, such as The Consumer Product Safety Commission, The Department of Energy, the S.E.C., and others, for which Murray could not develop compliance costs. [Chart 126] Here too, if we start making tradeoffs, we will need to compare that number to, for example, the total industrial R&D investment made last year by private companies, which is only something a little over $30 billion. So we are spending something like four times as much on regulation as we are on all private R&D investment in the United States. Of course, even these numbers do not include the enormous hidden costs to our productivity and innovation from the underlying adversariness and ambiguity of all this regulatory activity. In the drug field, for example, the evidence overwhelmingly indicates to me that the so-called "regulatory lag" has been an important cause of sharply reduced innovative performance.

As a society, we have been politically very active. I had a count made of the new social and economic regulatory laws passed by Congress. You can see that the decade of the 70's has been a highly productive one -- if you are interested in that kind of productivity -- both on the social and economic legislative front: from 27 regulatory laws in the decade of the fifties to 125 laws in the seventies. That is some growth. [Chart 125]

Again, Mr. Parkinson would say to us, "What did you expect?" Let me elaborate by referring to another dramatic growth curve. Some of the most admirable people I know are on Congressional committees, which have grown two and a quarter times from 1970 to 1978. [Chart 128] They want both psychic income and financial income. Their psychic income is often to leave their historic landmark on the legislative horizons of America, and they are doing it with great success.

Another subject is painful for me to talk about because some of my very best friends are lawyers. This is the growth of Washington lawyers in the non-Washington law firms. [Chart 127] The U.S. now has roughly twenty times the number of lawyers per capita as Japan and four times the number as West Germany. Like regulatory agencies and Congressional committees, the law is one of the great growth industries in America. Alas, I wish I thought it were related to economic growth in some positive way.

CHART 122

GROWTH OF FEDERAL GOVERNMENT EXPENDITURES ON REGULATORY ACTIVITIES
($ BILLION)

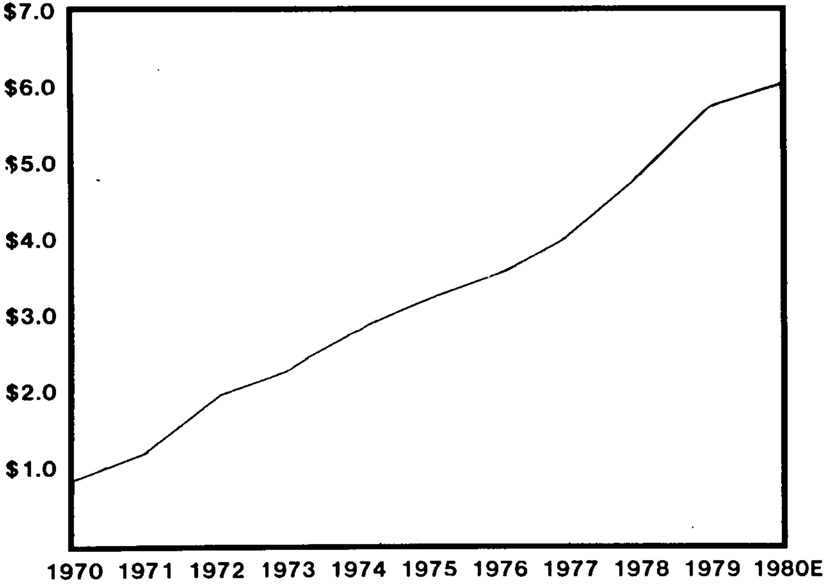


CHART 124

REGULATORY AGENCY STAFFING

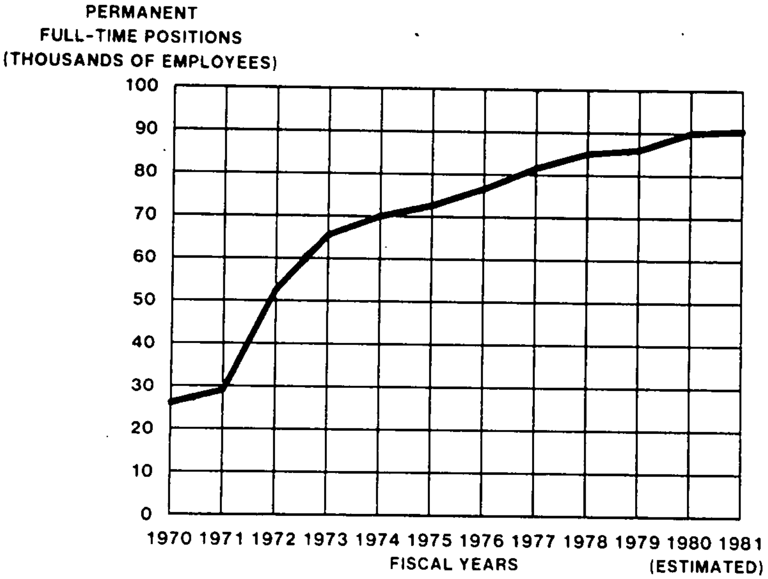
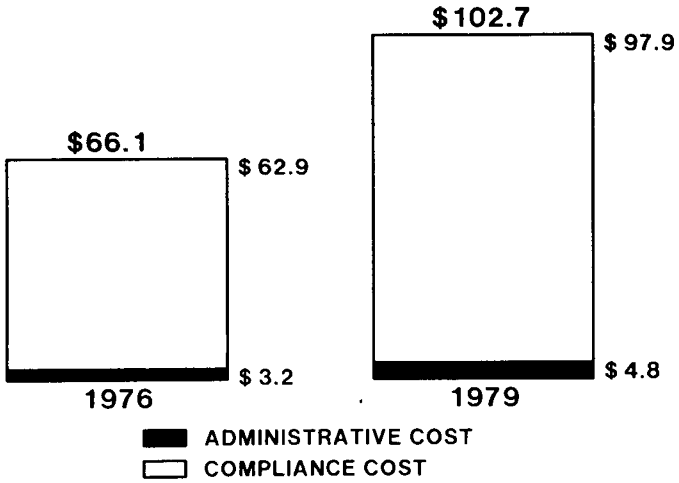


CHART 126

U.S. - COST OF FEDERAL REGULATION OF BUSINESS

($ Billion)



Weidenbaum's 1979 estimate based on applying Compliance Cost/Administrative Cost multiplier of 20 (1976) to 1979 budgeted cost to operate regulatory agencies

Chart 125

NUMBER OF NEW MAJOR SOCIAL AND ECONOMIC REGULATORY LAWS PASSED BY CONGRESS

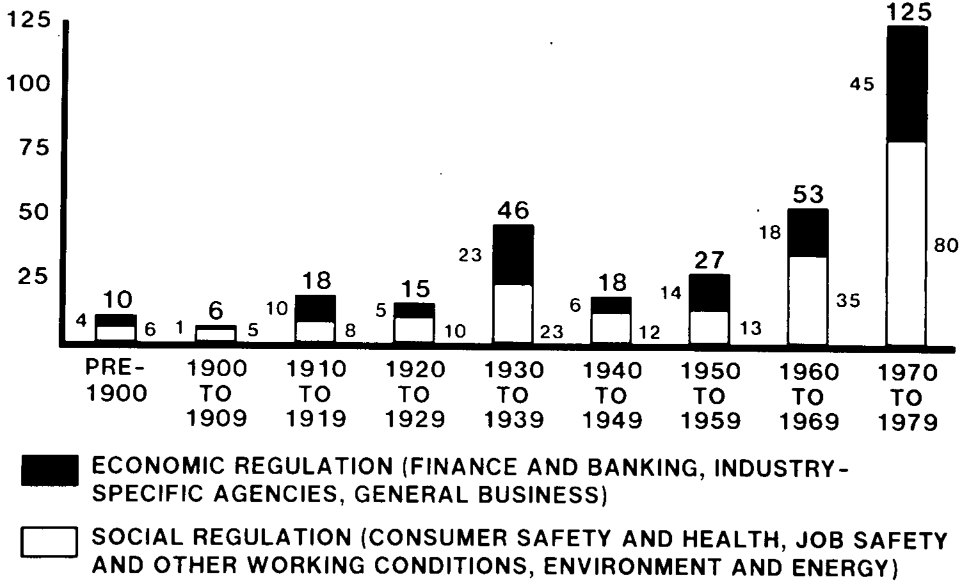


CHART 128

THE GROWTH OF CONGRESSIONAL COMMITTEE STAFFS

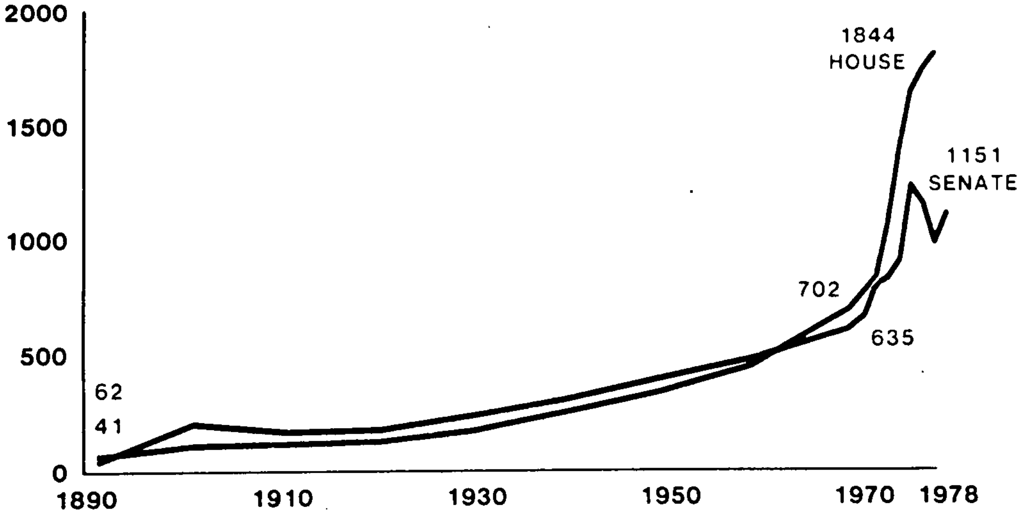


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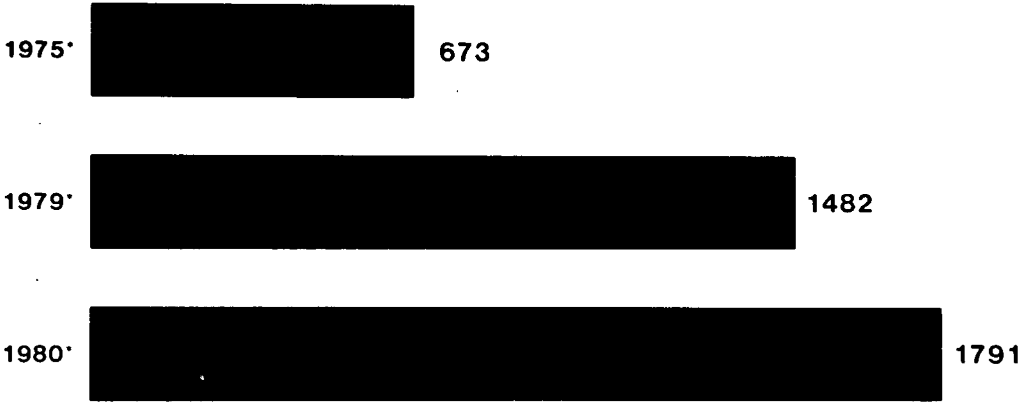
CHART 127

GROWTH IN NUMBER OF WASHINGTON LAWYERS OF NON-WASHINGTON LAW FIRMS



* AS OF JUNE 1

Some Things To Be Done

Very well, those are all the charts. Now, let me talk as briefly as I can about some things that need to be done about our compound crises -- in productivity, the economy, energy, defense, and ultimately the political system of the United States.

Management and The Productivity Crisis

Allow me first to speak to all of us as management people. I think when we look at this dismal performance of our economy at the macro or general level, we would like to believe that all these problems are at the level of the economy as a whole and that somehow if we just take care of such problems -- stimulating savings, investment, R&D, and the like -- then all of our other problems will be taken care of in the world markets. That would be a false message. These macro steps are absolutely necessary, but they are not sufficient.

I do not think that it is an overstatement to say that what these charts suggest is what we all know: as management people, we are facing one of the most profound crises that American management has ever faced. Like a lot of things, it all begins at home, at the micro level, that is, in our individual companies. One obvious piece of evidence that management plays a decisive role is this: in many fields particular U.S. companies are doing well indeed, at a time that others tell us they can't compete.

Let me elaborate on several of these areas.

Some of the boards on which I serve are finding in their studies of their Japanese competition that there is something going on here beyond just newer manufacturing equipment. Put bluntly, we are often getting beaten on the shop floor. For example, in the case of the automotive business, we see the important effect of not having such rigidity in job classifications; and we see the important effects of having employees not only tied for lifetimes to "their" companies, but tied to the overall interest of "their" companies. If we had time to go into some of the more definitive studies, we would see that this in turn results in employees who are willing to handle many more machines, who are very much involved with quality of the overall product, who run and not walk, who often do not have coffee breaks and who are preoccupied to a much greater extent than our employees with the general welfare of their companies. It's hard to overlook the fact that Japan, compared to U.S., has recently experienced less than a tenth of the working days lost per 1000 employees due to industrial disputes.

We are also seeing production control and material handling systems that I think most objective observers would say are significantly better than ours. When we get into these companies and try to find out what they are doing, why their production lines are shorter and why their turnover of work-in-process inventories is so much higher, we see such phenomena as vendor trucks unloading right onto much shorter and straight production lines, many fewer store rooms, and of course much less work-in-process inventory.

On the automated equipment side, we saw in the case of television that our Japanese competitors are doing substantially better. We see automatic load grinding machines; we see preprogrammed devices that change models without slowing down production; we see that probably at least half of the world's robots, are now made by about 120 Japanese robot manufacturers.

One company that I work with, also observed sadly, that their leading competitor globally probably has 40% less overhead than they do. This news obviously must be something less than thrilling for those who are in the overhead.

Thus, we have fundamental attitudinal and competitiveness problems that frankly pose not just union but the basic questions of how to motivate our employees and how to organize and restructure our businesses. The answer starts at the highest levels of America's management.

In this connection, the most forward-looking companies that I know are taking the view that in the same way, for example, that the Japanese imported our technology not too many years ago, why should American companies not now import Japan's productivity knowhow? Some of our most sophisticated companies have set unusual productivity exchanges with Japanese companies. We must get "oriented" -- if you will forgive the unforgivable.

Perhaps an encouraging word. Akio Morita, Chairman of Sony, has told me that in their Sony TV plant in San Diego, where they produce most of their larger color TV sets for the U.S. market, their productivity and quality levels are already virtually identical to what they achieve in their Tokyo facilities. To be sure, it is a company union, but let's be careful not to put too much of all this on the backs of the American worker and not enough on the backs and minds of American management -- engineering management, manufacturing management, personnel and labor relations management, and so forth.

In any event, I do not see how one can look at this melancholy productivity performance without examining seriously the question of basic organization, including of course worker and union relationships. How to achieve more of this sense of common identity will be in my view one of the great managerial challenges of the next ten to twenty years.

Speaking of the long term, let us not forget the Japanese criticism that American managements are not sufficiently long-term in their outlook. Just because it has become a cliche does not make it invalid. In that connection, I heard a provocative proposal recently -- that our top, senior executives should get a significant part of their incentive bonuses five years <u>after</u> they retire.

It is also vital that we become much more sophisticated in our political communication. But more of that later.

The Productivity Crisis At The National Level

First of all, it seems to me that there are some things that should not be done. I would hope our political leaders, whoever they may be -- the new economic and political doctors -- treat this for what it is. It is a chronic disease. It is a progressive disease. It is in part an iatrogenic disease, i.e., caused by the "doctors." It reflects many years of overeating and indulgence. We have indulged ourselves in the fantasy that we can have it all. We have too often indulged ourselves at the foreign policy level in believing that we can have foreign policies unconstrained by "mere" economic issues. Indeed, who would not rather have an unconstrained foreign policy? We have indulged ourselves in the concept that we can be the moral leaders of the world and be the principal actors in global morality plays of various sorts. We have indulged ourselves in the concept that we can live off our past and not invest in our future, that we can redistribute wealth we have not created. We have indulged ourselves in the fantasy that the sum of the whole array of special interests in America in some wonderful, magical way adds up to the general interest. We have avoided making hard choices because we did not think it necessary. We have become experts at the vastly easier and more pleasant task of distributing benefits. We are now at a time in our lives when we have no alternative but to learn how to distribute costs.

Some Things I Hope We Don't Do

I would hope we could resist two or three quick-fix, interventionist solutions that I am distressed to see becoming increasingly popular. The first starts with analogies to the Titanic and concludes that what we need to do is stabilize the decks. A year's price and wage freeze, for example, would be a way of stabilizing things. It is beyond my comprehension to understand how we can import 20% to 25% of what we produce from a world economy that is completely uncontrolled by the U.S. and at the same time how we can be serious about extended price freezes.

We are hearing suggestions that we revive a new Reconstruction Finance Corporation, into which we would put in something like $100 billion. I was a reluctant but negative witness on the Chrysler matter, which I considered a sad and seminal point in America's industrial policy. The senator from Michigan was not pleased with what I had to say about it and he asked me, "Don't you understand that the Japanese government help their industries?" How, he asked, can any sophisticated person not understand that we should help ours? I told the senator that it is my understanding that the Japanese put most of their political and financial resources into the industries of the future, as they are now doing with computers and telecommunications; and that we on the other hand protect the lower technology industries, usually <u>after</u> they have lost their competitive edge. In a world of limited resources, the resources we commit to these industries are resources not available for either more dynamic enterprises, or more future-oriented purposes. And in my 2 1/2 years in Washington, I came to the conclusion that Federal intervention in such industries was nearly always a long-term euphemism for protectionism. Besides, have we already forgotten the scandals, charges of political favoritism, and just plain arbitrariness that led to the death of the old RFC?

I also hear elaborate proposals for national planning and for strategic selection of industries. My response to that is: God save us all! The concept of any set of bureaucrats in America being able to select the industries of the future boggles more than my mind. What really boggles is the bland assumption that even if we had such a plan, the political log-rolling process of America would permit it to be implemented. I can recall that one of my most difficult assignments in the Government was negotiating still another textile agreement. I can remember that at one point the Attorney General of the United States was arguing with great passion that the textile industry was a "strategic" industry. It was a "strategic" industry because, he argued, one out of eight jobs was in the textile industry. Not irrelevant to the definition of "strategic" was that, in the 1968 Presidential election, the four border states where textile industries were located contributed handsomely to Mr. Nixon's victory. Mr. Nixon, like others before him, had made deals, (he at least published his deals, which I think is to his credit). But the idea that the apparel business, including I suppose tennis shorts and girdles, could be defined as a "strategic" industry in America, gives us some idea of how likely it would be that those so-called strategic industries would, in the politics of the Congress, remain the same strategic industries that the global planners had picked out.

I am reminded of the story of what happened to the Canadian economy when they too embarked on a grandiose plan and at one point it was said, "How can we miss? We have American resources, the British form of government, and French culture." About 50 years later the results were not very good and apparently a historian found that a few things went wrong. "Alas," he said, "we ended up with the American culture, British efficiency, and the French form of government." Thus, the concept that bureaucratic prescience can be courted is to me as incredible as the concept that we can implement such plans once they are made.

The Fundamental Problem -- Finding the Resources to Invest In the Future

The fundamental issue that these charts illuminate for us is that somehow we must learn that we have limited resources and that we must get somewhere between, I would say, 3% and 4% of our GNP per year to invest in our future -- in plant and equipment, in technology, and in defense. We are unfortunate to have to live in an era of compound crises and simultaneous maximum dangers for our country -- maximum danger from the Soviet Union, maximum danger from inadequate, insecure supplies of vital energy, and maximum danger from the lack of an underlying productivity thrust in our economy.

Now, the question is where are we going to get an additional 3% or 4% of our GNP, given the history that I have reviewed? I remind you that increased productivity probably reduces inflation over a period of time by very roughly the same percentage points as the increase in productivity, and very likely by somewhat more. However, given two-digit levels of inflation and low, one-digit productivity improvements, working on the supply side, while vital, is not enough.

Needed: Better Processes to Control Spending

Clearly, we need to do something new at the federal budgeting level since the traditional trade-off processes are simply not working. This is not the place to discuss whether we should have budget limits as a percent of GNP, or supra-majorities in spending bills, or binding multi-year budgets. But I think any American interested in securing those resources for our future must come to grips with the process by which we are going to bring this spending under control. It has gone wild.

There is no way I know that we can come to grips with this spending problem without looking at the so-called "uncontrollables" and "entitlements" in our federal budget and coming up with a politically viable solution. For example, we now have 100% indexing on very large elements of the entitlements -- social security, federal pensions, veterans' benefits -- and a great deal of that is tax-free. Something around a quarter of the federal budget -- or $150 billion -- is now 100% indexed to the rate of inflation. In the last year, we were confronted with what I found an interesting irony. It did not occur to us as a bit of an assault on equity and logic that many Americans were getting 14.3% increases in the social security, tax-free, at the same time that a wage guidelines policy limited the workers producing the wealth to 9 1/2% guidelines, taxable of course.

Most of these entitlements, incidentally, are considered "uncontrollable" expenditures, which is a curious misnomer since they are subject to the same majority Congressional vote as is the federal budget itself. I understand that social security payments have been adjusted ten times, mostly upward, over the last eight years. Perhaps in candor we ought to talk only about "upwardly uncontrollable" expenditures.

If we are going to change, I think we are going to have to look at unpleasant alternatives seriously, such as making significant changes in the methods of indexing. Make no mistake about it, this is an enormously difficult political task. For example, in recent weeks I was saddened to observe that a brave Congressman had the courage to venture forth with the idea that we should change the indexing on Federal pensions to once a year instead of twice a year -- not change the 100% indexing, just alter the frequency of adjustment. After some early support, he was saddened to observe that he lost out on even that minor change, and that he was even beaten by a constituency that are often folk enemies, the so-called bureaucrats. Similarly, indexing military pensions once instead of twice a year had lost earlier, at a cost to taxpayers of $1 1/2 billion a year.

I also believe that we are going to have to look at the unpleasantness of burden-sharing in which some of us who are more affluent are willing to accept part of the additional burden. For example, some taxation of social security is probably an option that will have to be explored. Social security tax exemption amounts to about $10 billion a year, that is, about 1/3 of the industrial R&D expenditures in America. I am aware of the fairness argument that it was contributed after tax in the first place. Still, those are the sorts of very tough political choices we are going to have to consider.

Could we change the social security retirement age to 68? This would be very difficult and certainly immoral to do in a hurry. On the other hand, if we were to consider two things, first, phasing an increase in the social security retirement age to 68 over 15 years, perhaps a year every five years, and second, providing new incentives for individual retirement accounts by encouraging businesses and people to save and plan for their own retirements, we might then be able to have a fair package that could be sold. I remind you that something on the order of half of America's workers have no pension at all.

There is an undeniable relationship between high Japanese saving rates and much greater Japanese dependence on private retirement plans. Money that individuals or companies put aside for retirement is truly a savings plan and is available for long-term investment. "Retirement" that goes into the social security system is not an investment or a savings program. It is a spending program and it is time that we called it that. So, if you want to be pro-savings and investment, I do not think you can avoid thinking about the related issues of social security and private retirement plans.

Mutually Phased Increased Investment and R&D Incentives and Reduced Growth in Government Spending

On tax incentives, I would share the conventional view that they should be tilted toward investment, saving, plant and equipment, and R&D. However, I believe we are going to have to think of some mechanisms by which we simultaneously control government spending on a phased in basis and at the same time phase in new incentives over perhaps 5 years or so. If we simultaneously announce a comprehensive program of incentives, spending cuts, and regulatory reform that amounted to nothing less than a restructuring of U.S. economic policy, we would give our investors and our companies signals of confidence that we really are going to change this country's direction and reduce inflationary expectations -- but not end up with extraordinary government deficits in the meantime that are in themselves inflationary. In that regard, I am not sympathetic with the Kemp-Roth formulation alone because I think it avoids the awkward question of what you are going to do about government spending and government deficits in the meantime.

Increased R&D

On the technology side, there is much that we can do. I will just mention two or three things. At the level of government support, I am much in favor of more government support for basic R&D. Second, with regard to foreign innovation and R&D, I think this country is at the point where it should seriously consider encouraging the importation of technology and productivity - enhancing know-how. And yet, ironically enough, our tax laws, as I read them, say that if you import technology you cannot write it off, but if you decide to do it yourself, you can. This is one of the anomalies of a country that is not used to participating in global change. There is obviously a lot we can do on other R&D incentives: faster write-offs of laboratories and equipment and of prototype plants, stimulating the formation of smaller entrepreneurial, technologically based companies, and the like. Finally, the patent system needs a good overhaul.

Less Regulatory Cost

On the regulatory side -- this is another speech, and one speech from me is probably one too many -- the regulatory burden, I believe, must be resolved in a socially compassionate and sophisticated way. To amplify the point of how some of us are perceived, I recently heard the neutron bomb referred to as the Republican weapon: "It destroys the people but leaves the property intact."

In this competitive world of limited resources, all regulatory expenditures must be made in the context of trade-offs, of costs versus real benefits, of determining the most efficient ways of achieving rationally-chosen targets. Whether we get at this through sunset laws or sunrise laws, or revised legislative histories and procedures that require assessments of the regulation's impact on cost, productivity, and innovation rather than simply achieving some absolutist result, it is clear that many of the regulations have gone far beyond the point of being worth the benefits. We have become so unrestrained by costs that in some of these regulations the last two or three percent of what we are trying to do, as on emission controls, is reportedly costing us 70% to 80% of the total cost of these regulations. (I have often wondered what might have happened to some of these environmental regulations if the energy crisis had happened before, instead of after the environmental movement bloomed.) And some of the regulatory rules have been grotesquely trivial -- classic examples being OSHA rules on the design of toilet seats and the height of fire extinguishers. These illustrate why it may not be a bad idea to propose a temporary moratorium on new regulations until we can get our regulatory act together.

Beyond this, clearly it makes sense not to tell American industry both what has to be done and how to do it, but to tell them the result and let them find out the most cost-effective and market-oriented ways of getting there.

And finally, I am less adverse than some to put regulatory activity more in a judicial framework. Regulators are often looking for things to do. Courts are not looking for cases. The tilt away from administrative review toward judicial review shifts the burden of proof and reduces the current bias to overregulate.

Whatever we do, let us be sure we translate the payoff to the economy. A 25% reduction in the costs of our regulatory burden -- surely doable when one considers their explosive growth over the last decade -- would release enough resources to double the R&D investment by private industry. To help achieve these objectives, I am attracted to the idea of requiring regulators first, to construct an audited, "compliance budget" of what that agency requires the private sector to spend to carry out their regulatory goals, and second, to put a limit on these costs. Carrying this notion a step further, there is no reason we could not put a limit on the aggregate costs of all regulatory activities. One of the important reasons, of course, for the malignant growth of government by regulation -- as contrasted to taxing and spending -- is that regulation is less constrained by public knowledge of the costs.

A Stimulating Export Policy

On exports, I am preaching to the choir here, I know. We are facing a plethora of new export control regulations -- Arab boycotts, corrupt practices, human rights, and environmental restrictions. In the kind of world that I like to dream about -- where we look in advance at benefits and where we look at costs -- I wonder to what extent those policies were ever critically debated. I wonder if anybody sat down in advance and said, "These are the presumed foreign policy benefits. What will it cost us in terms of reduced exports and our domestic economy?" A government official tells me that one estimate -- after the fact unfortunately -- was $5 to $10 billion and that is probably low considering what is happening in the Middle East. Still, at $10 billion, the kind of calculation that we are going to have to learn to make is: "Well, how many jobs is that?" It is probably four to five hundred thousand jobs. What would it cost us to produce those jobs in other ways? What are the lost revenues to our economy? What does it do to inflation, because that last 10% or 20% of exports really make a difference in unit costs? These are questions that I am confident were not even asked at the time those foreign policies were evaluated. It seems clear to me that most of these export controls -- not clearly related to genuine national security interests -- have outlived whatever usefulnes they ever had.

To take another example, we have a set of export attitudes that suggests that our international employees should in some way be either punished or reprimanded. We tax salaries. We tax incentive bonuses. We tax fringe benefits. We tax cost-of-living allowances. We are the only major country in the world to do all of those things to the very employees who play such a major role in increasing our exports, our jobs, and our foreign exchange earnings.

Let us as management people also resolve to remedy any of our diffidence or indifference to exports. In other words, it isn't just national policy; it's often management policy as well. Let us be honest. To too many American firms, exports are still a MEGO subject or at most a fringe problem; For example, 80% of our exports are done by only 2,000 companies. Ask a Japanese businessman some time what his market share is. My guess is that he will either give you his global market share (he has learned the profound effect of global share on unit costs) or he will ask you which countries you are interested in and then proceed to tell you. Too many U.S. businessmen, as well as the Anti-Trust Department, still think in terms of U.S. market share only.

And while I am giving you free advice -- which may approximate its value -- I urge you who have not done so to tour Japanese plants, not just to see first hand how they are attaining those inspiring productivity increases, but to see the decisive role of exports in explaining their much larger production runs which bring down their costs even further.

Stimulating Foreign Investments in the U.S.

On investment, I would hope the business community would stand up and do something it does not do very often -- which is to rid itself of some of its own ambivaylence (as we used to say in Nebraska). We have gotten into a very interesting habit on global economics whereby we use a whole set of what a friend of mine calls dysphemisms -- it's the antonym of euphemism. For example, we are "assaulted" by foreign companies, and we are "flooded" or "invaded" by imports, as though some kind of hideous economic war has been inflicted on us and that we are all being damaged. We obviously need a much more affirmative attitude toward encouraging foreign companies not only to bring their money (that we need), but increasingly to import their know-how (that we very much need) to enhance our productivity.

More Defense Burden-Sharing By Our Affluent Partners

On the defense side, I would simply say that we need to develop some political, practical ways to achieve more effective burden-sharing.

Let me illustrate this. I indicated to my colleague, Jim Schlesinger, that I would be interested in what it would cost to provide a permanent naval task force in the Gulf area, since it can certainly be argued that our allies have an enormous interest in protecting those sea lanes. He came up with an assortment of task forces of frigates and submarines and so forth that amounted to a total cost of about $15 to $20 billion. I wonder if, for example, our Japanese friends who are only spending .9% of their GNP on defense could not on some basis -- with some political imagination to be sure, rather than relying slavishly on a 35-year-old security treaty -- be persuaded to contribute significantly to at least the equipment cost of such a naval task force. Japan, of course, has enormous steel-building capability and seriously under-utilized shipbuilding capability. Even in the unlikely event that they contributed over a 3-year-period all of this naval task force, this would only amount to about .5% of their G.N.P.

In discussing some of the political alternatives with my colleague, George Ball, he suggested we explore some version of lend-lease whereby Japan provides the ships and others operate them. What I am not talking about is a public confrontation because these tend to be counterproductive. I am simply talking about the issue of fairness in burden-sharing. I think with some imagination and sensitivity it is quite possible that this could be arranged, or should be arranged. We simply must bring responsibility and power into closer balance.

Energy -- More Balance Between Increasing Supply and Reducing Demand

On the energy front, I would like to urge that part of the increasing political sophistication that the global economy requires of American business is not just to lecture the U.S. on increasing supply. My list of things we can do to increase supply -- whether releasing public lands and waters, or using more coal and nuclear power -- is at least as long as yours. But reacting as Americans, I think we must also look at where the broader national interests lie.

I, for one, am seriously alarmed at the implications to this economy of the supply vulnerability that we are facing for at least the next five years and probably the next ten years. We may have two million barrels less oil coming from domestic sources by 1985. None of the increased energy supply options -- off-shore drilling, synthetics, nuclear, coal and so forth -- does anything really significant about energy supply until the late eighties at the earliest, and more likely, the nineties.

In the meantime, we are dependent on a group of Mideast countries which are obviously unstable politically. My colleague, George Ball, took me on a tour of the Middle East and pointed out to me then -- before the Iran and Iraq war had reduced oil supply by still another 4 to 5 million barrels -- the obvious risks that one or more of those countries might seriously cut back oil production. We as a country are virtually unprepared for this in the eighties -- almost defenseless.

What are we as business people going to do about this? I think that once this election is over, more businessmen have to get more interested in energy conservation, and I am pleased to tell you that several of us have been persuaded of this. Fred Hartley of Union Oil, Tom Clausen of the Bank of America, Charles Brown of AT&T and I are undertaking a major effort to raise some money from the business community to further encourage an even more serious program of energy conservation.

It is our judgment that it will make us far more credible on supply alternatives if it is clear that we are equally persuaded that we should conserve more energy. We cannot ignore the painful fact that if we were as energy efficient as our OECD partners, we could be oil exporters.

As I review the Vietnamish energy alternatives on the conservation front, I am coming to the conclusion that there is no practical alternative (remembering that with 5% of the population we consume 49% of the world's gasoline, and 30% of world oil consumption) to a very large gasoline tax in this country, probably phased-in. I think it would do a great deal to reduce dependency on imported oil. We could figure out how to recycle it; and we could figure out how to minimize the effect on inflation. Those recommending this will be called naive and will be told that it is politically impossible. But three years ago we were also told that capital formation incentives were impossible. And I think that even the Carter Administration's tax proposals, more than half of which are now business-oriented, would have been considered absolutely "impossible" only two years ago.

In terms of emergency storage, clearly we should be building our stocks -- to something like six months -- as part of a comprehensive energy program, which to me must include a <u>good defense as well as a good offense</u>. I understand we now have less than 100 million barrels, or something like 2 weeks of imports in our strategic oil reserve.

In my judgment we must also strike a major deal of some sort with OPEC, what we on the Brandt Commission called a "Concordat," not just on oil supplies and prices, not just to help much more with the agonizing Third World debt problem, but also to increase enormously oil exploration in the Third World. Such a "Concordat" would be difficult, if not tortuous, to negotiate. However, we have no alternative but to get into a real and long overdue dialogue with OPEC. They, the real nouveau riche, have the oil and the financial surpluses to make a difference.

Some Concluding Thoughts On What Must Be Done

I would like to end on an optimistic note. If I were coming to this country from another planet, and I were to look at the incredible resources of energy, of food, and of technology that the U.S. possesses, I would say that you Americans have unparalleled economic strengths. I would say that you Americans have usually responded to crises, and perhaps only to crises. Your problem is that the American people do not yet believe that they have these three compound crises -- energy, productivity/economic, and defense. What is clearly needed is for your people to be persuaded that there is such a crisis in the same way that Germany was persuaded by a common sense of crisis, both political and economic, to end their inflation in the twenties.

How can we do this? I suspect that we can do it in at least two ways. In the first phase, businessmen must become vastly more politically sophisticated and courageous and come up with politically viable alternatives that will play not only in Peoria but in Washington. And that does not mean that we suggest that we cut out all of the government spending programs for the poor -- which is something that is both immoral and imposssible -- but to come up with practical programs of reducing these government expenditures in a way that is both morally, politically, and socially viable.

We must come up with burden-sharing that makes moral and political sense, if we are to find the additional 3% or 4% of GNP annually that we must find to invest to meet our productivity, energy, and defense crises. We must show the positive long-term connection between productivity, economic growth, quality of life, and advances in egalitarian justice. In the shorter term, we must establish that investment in our economy is not at the expense of equity and social justice for the lowest, poorest end of the socio-economic spectrum.

What we need are compassionate conservatives. Is that a contradiction in terms? Can one at the same time be both socially compassionate and fiscally conservative? And while it is admirable -- and I would argue it is even essential for a contemporary conservative to feel compassionate -- feelings are not enough. He must act on his compassion. So the problem becomes, how can we be against inflation without being against human beings? How can we husband (or should I say, how can we spouse) our resources so that the dollars we spend find their way into those activities with the highest return in salvageable human lives?

To do all this, we also need informed, passionate, and compassionate generalists to form effective majorities and a national consensus for the general good. One of the reasons we must build a truly national consensus is that it is a long-term problem, both in its causes and in its solutions. It will transcend congressional and presidential elections and even decades. Thus, we -- all of us -- must forge a bipartisan consensus. And to do this, we must acknowledge that the institutionalized adversariness that has spread throughout our economy and our society is a deadly disease. Until the American people are genuinely persuaded that they can not have it all -- that they must choose -- who can blame them for continuing to assume they can have real increases in their standard of living and all the quality-of-life improvements, such as an ever cleaner and ever safer and ever more secure environment, and at the same time all the so-called entitlements and equal "rights"?

Secondly, we must become much more sophisticated in communicating to the public the nature of these problems. I believe the solution must start with the media. For example, in the White House in which I worked, someone who was once called an "evil genius" -- Charles Colson -- used to say that he would rather have 20 seconds of Walter Cronkite on the nightly news shows than every front page in America. Lyndon Johnson reportedly got really concerned when Walter Cronkite appeared to have turned against him on the Vietnam situation. I think those of us who care about these issues must sit down with these top people in the media and try to persuade them of the nature of the crises that confront us. And when the media ask for our public commentary, let us not forget that the news media are by definition interested in news. The typical speech we make about free enterprise is not news, I guarantee you. Real news will often involve controversy and courage, and a willingness to risk some of our collegiality to gain some credibility.

So, while we now may have ignorance and apathy, what we need is sophistication and will. And the encouraging thing is that up to now we have everything else that it takes, but that. The poet Yeats said of an earlier time "the best lack all conviction while the worst are full of passionate intensity." Today, some of the "best and the brightest" seem to be telling us that there are no solutions while some of the others offer the quick fix and the easy solution. My own view is that there is only one kind of solution -- the long, hard solution. We have told the people what we thought they want to hear and they are certainly no better off for it. In fact, President Carter's decline may be dated by historians from the moment last year when he came down from the mountain to preach the strange sermon that a malaise was abroad in the land and that the people were somehow responsible, that Americans had, unaccountably and to their detriment, lost faith. But in all fairness, it was the same President who presented quite a different message three years before -- one with enough resonance among our people that they elected him. That message, of course, was that we needed a government "as good as the people".

The American people, in my view, know we are in trouble. They yearn-- indeed they hunger -- for greatness once again. The American people want to know the truth. They want to know the tough and the right questions. They want to know the answers. They want to know the costs. They want to know what they are supposed to do. They want their leaders -- their business leaders, their union leaders, their minority leaders, and their political leaders -- to get together to tell them the way it is, to tell them what needs to be done, and to tell them why.

In military terms, the American people are looking for the sense of the platoon, of the larger society, of a positive purpose to which they will contribute. Can we provide them with a sense of the future? That is the question with which I leave you.

Representative REUSS. Thank you very much for your constructive testimony, Mr. Peterson.

I share your feeling that it perhaps did take a Republican President, elected with a very considerable mandate, to jar everyone into new thinking about the size of the Federal sector, about the unfelicity of continued budget deficits, and about the need for regulatory reform.

And I certainly share your feeling that some judicious reshaping of that program is needed.

Mr. Richmond and I recently asked our Joint Economic Committee staff not only to take the Reagan administration's assumptions about what was needed by way of military expenditure and what was needed by way of overall tax reduction, both of liberalized depreciation and the Kemp-Roth income tax reductions, but instead to look at the roughly $52 billion of budgetary savings which the President has in his mind. We asked the staff to see whether it wasn't possible to make savings of exactly equivalent amounts, $52 billion, and avoid what we regarded as the twin evils of the Reagan-Stockman approach; namely, cutting down unnecessarily on the school lunches, the health programs, and the other programs which benefit the truly needy; and second, the cutting down on the programs such as investments in human capital, investments in infrastructure and research, which are important on the supply side.

We call this project our share-the-burden budget, and I want to enter into the record of this hearing, without objection, a full copy of this budget alternative. Since this budget alternative will be part of the hearing record, I will today share with you some of the ways which the staff—I think with considerable ingenuity—showed what can be done.

[The budget alternative referred to follows:]

THE "SHARE-THE-BURDEN" BUDGET[1]

An Alternative to President Reagan's $51.2 Billion Expenditure Cut Proposals

(Fiscal year 1982 budget revisions, March 1981)

This alternative is designed to provide the targeted $51.2 billion budgetary savings of the Reagan proposal, without necessarily subscribing to that particular target. The savings would be obtained by the following four principles:

Simplicity—twenty-two budget changes are proposed rather than the Administration's hundreds;

Equity—the Administration's sharp cuts in programs for the needy are avoided;

Economic efficiency—this proposal also avoids the Administration's counterproductive slashing of programs which increase productivity and economic efficiency (investment in infrastructure and job training) and instead eliminates wrongheaded incentives which reduce efficiency (such as over-incentives to consume);

Civil courage—powerful interests would have to pay their share.

The Administration has chosen to cut spending and the budget deficit the hard way: by making crippling cuts in hundreds of relatively small but vital programs, from legal services to Amtrak. These cuts inflict maximum damage—on the poor, the elderly, the sick, on schoolchildren, and on economic development projects such as mass transit, urban water and sewer, railways, and many others—for minimal savings, a few millions or at most a few hundreds of millions in each case. The result is that the Reagan budget achieves its $51.2 billion in savings at the expense of a comprehensive attack on social programs.

[1] Prepared by the staff of the Joint Economic Committee.

The purpose of this proposal is not to avoid needed cuts in waste and abuse in all government programs, but to outline a way to share the burden of reducing government across segments of society who have not yet been called upon to contribute. The cuts are achieved without touching the Reagan Administration's proposed military build-up, its depreciation proposal, or its general income tax reduction. In short, Congress could theoretically acquiesce in every major part of the Administration's comprehensive economic package, and still save the vitally important programs for human and economic development which have been built over the years.

The "share-the-burden" budget

[Fiscal year 1982 savings, millions of dollars]

Total savings	52,689
A. Spending reductions	15,754
1. Cut waste from the Department of Defense budget and improve efficiency in procurement and R. & D. (CBO estimates $16 billion savings over 5 years)	3,000
2. Savings in the medicare and medicaid programs through enactment of the Hospital Cost Containment Act	1,400
3. Savings possible in the food stamp program through improved administration	800
4. Index annual increases in social security benefits to the increase in the CPI or the increase in average wages, whichever is lower	3,815
5. (a) Increase military and Federal civilian retirement benefits in line with inflation annually rather than semi-annually	1,696
(b) Index annual increases to the increase in the CPI or average wages, as in No. 4	315
6. Terminate funding for the Clinch River breeder reactor	175
7. Terminate spending for new construction on the Interstate Highway System (savings of $3.7 billion in 1982) but increase funding to maintain the existing system	2,300
8. Terminate spending for recreational and public lands highways	54
9. Terminate funding for three Interior water projects: Central Arizona project, central Utah project, North Loup/O'Neill unit	296
10. Terminate nine Corps of Engineers water projects: Tennessee-Tombigbee Waterway; Libby Addition; lock and dam 26; Red River Waterway; Richard Russell Dam; Yatesville Dam; Skiatook Dam; Candy Dam; and Stonewall Jackson Dam	543
11. Increase airport user fees for corporate and recreational aviation	800
12. Impose waterway user fees, to recover one-half of direct costs	560
B. Better enforcement	5,300
1. Fully fund Economic Regulatory Administration in the DOE, to fully recover petroleum and gasoline overcharges	5,000
2. Add $100 million to IRS budget for enforcement of taxes on interest (CBO estimates that $4 in revenues will be collected for each $1 added to the IRS budget)	300
C. Reduced tax expenditures	12,535
1. Repeal deduction for interest paid on consumer debt	6,040
2. Repeal deduction for interest on mortgages for other than principal residence	250
3. End excess of percentage depletion over cost depletion for oil and gas	2,360
4. End excess of percentage depletion over cost depletion for nonfuel minerals and for fuels other than oil and gas	960
5. Require that intangible oil and gas drilling costs be amortized rather than expensed	2,925

The "share-the-burden" budget—Continued

D. Increased revenues	19, 100
1. Double the excise tax on alcoholic beverages (current $5.3 billion)	5, 500
2. Double the excise tax on cigarettes and cigars (current $2.6 billion)	2, 500
3. Replace the current 4¢ per gallon excise tax on gasoline and diesel fuel with a 14¢ per gallon effective June 1, 1981, which would be adjusted quarterly thereafter in accordance with changes in producer prices ($13.1 billion in added revenues in 1982) less $2 billion rebate to essential users	11, 100

Representative REUSS. I will just run down a few of the points now, No. 1 is cut waste in the Department of Defense by $3 billion. Well, you can't quarrel with that, I'm sure. And a number which should interest you, annual indexing of military and Federal civilian pensions, $1.7 billion. Index social security increases to the increases either in the Consumer Price Index or to average wages, whichever is lower, $3.8 billion. Terminate spending for new Interstate highways, while fully funding maintenance, $2.3 billion. Repeal deduction for interest paid on consumer debt, $6 billion. Repeal the reduction for interest on mortages for other than a principal home, $250 million. Double the excise tax on alcohol, $5 billion. Double the the excise tax on cigars and cigarettes, $2.5 billion. And finally, increase the gasoline excise tax from 4 cents to 14 cents per gallon, which would yield about $13 billion. But then we would rebate $2 billion of that $13 billion to people who, for essential business purposes, including getting to work, needed that. We would refund them that.

Well, that raises a lot of money, and it doesn't interfere with either of the two principles which we thought valid; namely, don't kick the poor around and don't kick economic development around.

What do you think?

Mr. PETERSON. Well, I have a tendency for indiscretion, and I've never lacked presumptiousness. I don't think I'm prepared to fully respond to this program, but I notice several things in that that are in line with what I was talking to you here today on. I take it that you are suggesting that the Government retirement benefits as well as the social security program be indexed on a less generous basis. Needless to say from my prepared statement, the sooner we get at that the better, in my judgment. So I would certainly favor some such effort.

The gasoline tax situation, Mr. Chairman, if I might say something about that. While I am a nonpolitician, I guess I am realistic enough to know that particularly from the Canadian experience, that any politician that in today's climate suggests a large gasoline tax is perhaps in trouble.

Representative REUSS. Could I point out in that connection that the reason that Joe Clark fell, and the reason that some of us who have been advocating a carefully tailored gasoline tax increase have survived, is that our proposal would include a wiping out of the tax increase for all those who needed it to get to work and for similar business purposes. Thus, in effect, it is a tax on recreational—"let's all go for a drive this Sunday" kind of driving. It's too bad, but something has to cost a little more, and our feeling was that in the end that's a good way of standing up to OPEC. So I wouldn't conclude that it is a goner, because it has never really been tried.

Mr. PETERSON. My point would be the following, Mr. Chairman, that in the same way that we have a consensus today that I think would have been unthinkable a year or two ago about budget cuts and capital formation, I think if that same level of political courage and acumen were put for the next year or so to the energy vulnerability issue, we might be successful there too.

Now let me tell you what concerns me about our vulnerability. You and I and Mr. Richmond and anybody else that's interested can prune and shape this budget program any way you want, but I just returned from the Mideast. I have two colleagues, as you perhaps know, George Ball and Jim Schlesinger, who have not always agreed on every aspect of defense or foreign policy, but certainly, they both agree that we are unbelievably and unacceptably dependent on an area of this world that is remarkably unstable and unpredictable, where supply cutoffs are not only possible, but probably likely in the 1980's for a whole set of reasons that no one can predict. And under those circumstances, I think it is urgent that this country make itself far less vulnerable.

Now how would it do that? I think there are two ways of doing it. One, to reduce very significantly our consumption of oil and second, to do something really major about strategic storage. On the question of consumption of oil, as I go around the world, and if you have time to look at that study, I have some charts in there gasoline taxes around the world. It won't escape your attention that the taxes around the world are running somewhere between $1.25 and $1.75 a gallon.

Now here we sit with a tax of just a few cents a gallon with most of that money going to the Highway Trust Funds, and we wonder why the rest of the world questions whether we are really serious about saving energy. I am not an econometrician. I'm not even sure that I know what it means, but I have seen a variety of estimates on elasticities of supply and demand. I think a large gasoline tax has a chance of reducing our imported oil by perhaps as much as 2 million barrels a day.

Now let's just imagine what that would do for this country. In the first place, I think we import, don't we, something like 20 percent of our total from so-called "Arab OPEC" countries? This would go a long way to reduce that vulnerability dramatically. Second, if we were to have a really dramatic strategic storage program, not one that is 10 days or 2 weeks, but one that is what it ought to be, 3 to 6 months, I submit to you that this country would be in a vastly stronger economic and political position. Now that in turn would provide tax revenues that could be used for a variety of purposes.

These revenues could be recycled, obviously, the people that needed it the most. It could be used to pay for the strategic storage program. It could be used, incidentally, for what I don't see enough of in your program, if I may be honest with you, more incentives on the savings and investment and capital formation side, which I think are absolutely indispensable.

So I think the issue of, perhaps, a gasoline tax that is graduated so as to not give the impact too much in any one year, let's say, a 5-year program in which, we, at the same time have a major commitment to strategic storage, is one of the most important unmet agenda items in this country. And I would hope on a bipartisan basis that this Con-

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gress and the President and everybody could get this country—and forgive the pun—energized on that particular issue.

So I'm delighted to see even a start toward that program. I have not mentioned, incidentally, the enormous advantages to this country of reducing its oil imports by 2 million barrels a day. Let's just look at it from an economic standpoint. As I recall, that would save us something like $25 to $30 billion, having an absolutely dramatic effect on our trade deficit. It would have an extraordinary effect on the value of the dollar. This, in turn, would reduce our inflationary rate significantly and would reduce the flow of real resources out of this country.

So I'm extremely pleased to see at least the beginning of that effort here.

Thank you.

Representative REUSS. Your suggested marriage between an increased tax in gasoline—although a drop in the bucket against what other countries do—and using at least some part of the proceeds to develop a strategic petroleum reserve is precisely what we have in mind. We come out very strong for a strategic reserve which, unfortunately, every time you look around nowadays, is being chipped away at, because it turns out there isn't money to buy oil now for that purpose. Well, as you point out, it would be the best insurance we could get.

I want to make one correction. The reason you don't find in this list of budget-saving devices anything about true supply-side investment and capital equipment incentives is as follows. We believe in supply side incentives, but we would achieve the objectives by shifting some part of the general individual income tax cut in the direction of investment and capital equipment. That explains why they are not on this list. But we have no difference between us in the need, if you believe in the supply side, to get on with it.

Mr. PETERSON. Mr. Chairman, there is one other agenda item that I briefly referred to in my testimony that I'm not sure is covered here, and I would like to emphasize. I don't claim to be an expert on the Japanese economy, but I know more than I did 18 months ago. That much I can say. You are completely aware, I'm sure, of the numbers back here that show a much, much larger savings rate at the personal level. Incidentally, at the company level a very interesting thing is happening. In some of the companies I've been studying over, the employees are saving up to 25 percent of their income and putting it right back into the companies that they work for, which is a rather interesting concept of the relationship between savings and productivity.

But one of the reasons that the Japanese people save more, just one of the reasons, is that they do provide for more of their retirement, and one of the decisive differences that has finally dawned on me between our social security program which has at this point become a spending program, not a savings program. Now I would hope that as we fundamentally review the social security system, which I urgently hope you do over the next year—I know today the consensus isn't there—that you might consider ways of not only changing the—for example, the age limits or perhaps even taxing some of it, but that you try to marry it in some way with a retirement program that is genuinely a savings program, because that will make a decisive difference on the level of savings and investment in this country. It is my experience in industry, Mr. Chairman, you rarely take anything away in the benefit field without replacing it with something.

I'm suggesting that what is required is not simply a restructuring of the social security system, it is coming up with some, hopefully, alternative method of providing for the retirement of our people that has the indispensable element in it of being prosavings and proinvestment, because that is precisely what the Japanese have been doing.

Representative REUSS. Mr. Richmond has done a lot of thinking about just that.

Representative RICHMOND. Thank you, Mr. Chairman, I'm sorry I wasn't here to hear your remarks, Mr. Peterson. I was chairing a food stamp hearing for the seventh straight year, so it is a relief to get over here. Your remarks on conservation, certainly hit a harmonious chord. Why do you feel the Reagan administration has been so virtually anticonservation when you and I agree, if we can only reduce our imports by 2 million barrels a day, we could virtually have our OPEC problem licked.

Mr. PETERSON. Well, I don't know if I would characterize them as anticonservatism. It is entirely possible that they feel that decontrol, which to establish my Republican credentials I am for and was for, would serve to reduce demand through higher prices. I guess what I'm saying is, however, in my recent trip to the Mideast this was made even clearer, we are not dealing in a wholly rational market-oriented world in the Mideast, and what worries me is that we have waited so long to do something about the defense side of energy policy, which includes strategic storage, that all of the scenarios I have seen on decontrol, Mr. Richmond, and I'm sure you've seen the same ones, suggest that we will be very lucky if we maintain the current production of oil.

There are some who believe that it will go down a couple of million barrels by 1985. No one really knows until we find out, but I see no forecasts that suggest an increase. Now with the growth that will take place in our assumption, there is certainly nothing that suggests to me that we will be any less vulnerable by any significant amount during this very dangerous decade.

So I guess everybody interprets risk differently. My interpretation of the risks is that the possibility of a supply cutoff is sufficiently high that it is essential that we now take some extraordinary measures in that area.

Representative RICHMOND. I certainly agree with you, and of course this 10-cent-per-gallon tax we have on our share-the-burden budget is only an inflationary upgrading of what it was back in 1956, when the highway trust fund was started. In 1956, they started with a 4-cent-per-gallon tax. Just inflation alone should make that fund demand 14 cents a gallon. As you know, our highways in the United States are in miserable condition. There's no money in the President's buget to really maintain them properly. And under the Ruess-Richmond share-the-burden budget, we thought this was an ideal way to, first of all, help conservation and, second, start rebuilding or put people back to work rebuilding our highways and our bridges.

It is such a logical tax that I just don't know whether we will get much support from the Reagan administration on the savings incentives. We have an addendum to that in the share-the-burden budget which called for $1,000 a year per individual or $2,000 per family tax exemption on savings. That would be savings—to savings banks and thrift institutions.

In other words, my feeling is, the only way we are ever going to rebuild the Nation's No. 1 industry, namely, housing, is to provide some low-cost, long-term mortgage money. And the only way you'll ever get that is through S. & L.'s and savings banks. And the only way you'll ever get people to go put their money back into S. & L.'s and savings banks at modest rates of interest is to exempt the taxes.

So we called for a $2,000 per family exempti n which certainly ought to create an awful lot more savings among middle class people, don't you think?

Mr. PETERSON. Yes, but let me, if I may, put a somewhat different emphasis on this, and I would urge you to look at those tax tables in my prepared statement—we spent a fair amount of time getting that data together—which show we are really sending out, Mr. Richmond, to our people some extraordinarily mixed and contradictory signals.

On the one hand, we want savings and investment. On the other hand, we have a penalty for unearned income. I told you about the Israel view. They have found they have to come to this. I am wondering why, at a time that I thought we had a consensus on the Joint Economic Committee to encourage savings, to encourage investment in this country, why there would not be equally bipartisan support for not sending out those negative signals to people. I mean why should we be discouraging people from putting their money in savings accounts, in getting dividends. I mean, what is the point, what is the macropurpose that's served by that particular tax configuration?

Other countries, frankly, look at the United States and marvel at the extraordinary ambivalence we have in which our rhetoric says we want productivity savings and investment, and our tax system, as these tables suggest, just the opposite.

Now I'm not supposed to be asking you questions, but isn't there a consensus raised there, that we ought to be promoting savings and investment in this country?

Representative RICHMOND. I will leave that for the Chairman to answer in a moment or two.

How do you feel about the current depreciation formula, the 10–5–3? Do you feel that would enable industry to retool? I think the present depreciation formula is totally antiquated and any corporation in the United States, in order to maintain its equipment has to spend roughly double its depreciation account just to survive. Now that doesn't get you any new buildings or any new lines. That just allows you to maintain what you have.

So it seems to me we ought to modernize our depreciation code considerably.

Mr. PETERSON. Mr. Richmond, if you want to know what I really think. To show you the nonpolitician I am, if we have time sometime, I'll take you through what has happened to American net investment and real return. And in that, it will be clear that the fundamental problem of inflation is that we have not been charging off against our earnings the real depreciation and a more fundamental approach to the depreciation issue is to come up with some way in which what we depreciate is rooted in reality; namely, what the replacement costs are, instead of grossly overstating our profits as we have been.

Now the difficulty with that kind of a suggestion which I think, frankly, would be a more fundamental approach. And this is one of the problems, I suppose, that a citizen like myself has, who on the one hand, is delighted to see this consensus emerge, and on the other hand, does not want to be making suggestions that are so different from what is now being proposed, as to end up doing nothing.

In a more perfect world, sir, we would have gone beyond 10–5–3, I think, to a more fundamental approach to the problem which, I think, is replacement accounting on the depreciation.

Representative RICHMOND. So at least you feel 10–5–3 would be a step in the right direction.

Mr. PETERSON. It is a step in the right direction, but I remind you of the total over the next 5 years. I think I'm right on this. Something like 20 percent of the total or 22 percent, I believe it is, is oriented to the business tax side and some 80 percent or 78 percent is on the income tax side.

Representative RICHMOND. Those are just proposals?

Mr. PETERSON. Those are proposals, right. And I'm asking you the question as to whether, given, if we have a consensus that we want to increase investment in plant and equipment and R. & D., if some of that personal tax were moved toward investment incentives. If that wouldn't be more appropriate.

Representative RICHMOND. I'm inclined to agree with you. As far as consensus accounting, I think we'll have to hear from our Chairman.

Mr. PETERSON. There's one other thing that I would like to suggest to you, Mr. Richmond, that if we were starting over, which we aren't and I really am very grateful for what the President has accomplished. I would hope in the future that you could focus more attention on research and development and innovation. I happen to believe——

Representative RICHMOND. Which always has been tax deductible. Now why do you think that we have been falling so far behind on R. & D.? There has been no tax problem in that one.

Mr. PETERSON. Well, let's just take—as long as we've got the time, let's take my diagnosis of the problem which may or may not be valid.

Representative RICHMOND. That's one of the other illnesses of the United States.

Mr. PETERSON. That is one of the ultimate illnesses.

Representative RICHMOND. Two, would be the aging in the primary industries, and the fact that we have fallen behind on research and development.

Mr. PETERSON. Let's take studies of innovation, which I'm sure you're aware of, that certainly jive with my own personal experience.

One of the remarkable, unique aspects of the American performance in the decades of the 1950's and the 1960's was on the innovative side. And every study of innovation that I have ever looked at shows that somewhere between 50 and 70 percent of the commercial innovations—that is those that were successful—came from the small technological entrepreneurially based companies: The budding

Polaroids, the Xeroxes, the Hewlett-Packards, the Texas Instruments, and so forth.

Now, if you look at—let me give you a Wall Street view—the extent to which the formation of those companies has deteriorated.

I had one of our fellows count the numbers of small companies coming into the market in the 1960's—the latter part of the 1960's—and the numbers in the last couple of years. The numbers, as I recall, in the late 1960's were over—I think it was something like 500, or something of that sort. Over 500 such companies.

In 1978, that number had fallen to 29; 1979 and 1980, frankly, due to the capital grains tax improvement, saw a significant shift, but still were far below earlier records.

Now, here's another place, Mr. Richmond, where we're also remarkably ambivalent. I was taught at the University of Chicago that there is no such thing as zero risk and high rewards. You know, the world isn't constituted that way.

Now, these highly innovative enterprises, which have made an absolutely indispensable contribution to America, in my view, in the computer business and other fields, are extraordinarily high-risk ventures.

Now, what did we do in 1969?

Under some punitive concept on capital, we significantly increased the capital gains tax. Actually, I have had studies done of whether it is rational for a person, given the high risk, to put a lot of money in high-risk entrepreneurial enterprises.

And the answer is: He would have been better off not putting his money in these high risk ventures, given the capital gains rates.

I think there are quite a few things we can do for smaller companies, Mr. Richmond, that would not cost us very much. That would send out signals to the country once again that we really do want to encourage the Yankee inventor, the small company, to get going.

If you're interested in that, I would be glad to send you some studies on it. But there are many things that could be done.

Second, in big companies, for reasons that are not clear to me, we don't seem to understand the connection between innovation and investment.

I remind you that one of the reasons people build new plants is that they have some new products or new processes that they want to invest in. They just don't invest as an academic exercise. One of the reasons they do it is not just to increase supply; it is to make available new products, new processes that save money which comes out of research and development.

But those, too, are very high risk. If you were really interested in encouraging research and development and innovation—and I think that should be an important part of any comprehensive program—I commend to you the CED study on technological innovation.

One of these things they proposed, for example, is that you take a look at the building of commercial laboratories and prototypes, and permit writeoffs in the first year on those projects, to send out signals that you want American industry to increase research and development.

So, a second area, as the year goes on and this program evolves, I would hope this committee and others would focus on R. & D. technology and innovation.

Representative RICHMOND. One more question, before I go back to my food stamp hearing.

How do you feel about the establishment of a Federal RFC, in order to get basic industry retooled?

You know, in my wildest dreams, I can't figure out where U.S. Steel is going to get the necessary billions to modernize their steel mills; and where Anaconda is going to get the necessary billions to modernize its copper facilities; and so forth.

I believe the state of the Nation's secondary industries is probably not in too bad shape. But I know our primary industry has fallen far, far behind our major competitors, Japan and Germany, not to mention our transportation system.

Now, where do you think we're ever going to get that kind of money, unless we can resort to a Federal RFC?

Mr. PETERSON. Well, Mr. Richmond, I'm going to disappoint you and reassert my Republican credentials in the following way.

Representative RICHMOND. I am disappointed.

Mr. PETERSON. I was among——

Representative RICHMOND. Mr. Peterson, let me change my question, then. [Laughter.]

Do we agree that we have a pressing need to modernize America's basic industry and America's transportation system?

Mr. PETERSON. We have a basic need, as a country, to put a lot more into plants and equipment and research and development as a whole.

Representative RICHMOND. Let's say the two pressing needs would be basic industry—which really can't take care of itself—and our transportation system.

Now, where are we going to get money? Where are these major organizations going to get the money to modernize for the foreseeable future?

Mr. PETERSON. Well, let me give you a view that starts with Chrysler and works back from that.

I testified, as you wouldn't know, with the Senate Banking Committee, in the final analysis, saying I did not think it was a good idea for us to start down that track.

Now, why did I say that?

It wasn't that I was uncompassionate, or not interested in the human beings involved. No.

I had done some study, Mr. Richmond, of the British experience, for example. First in the auto industry, with British Leyland, where Leyland had, at the time of the so-called "help," 45 percent of the market. Five or 6 years later, Leyland fell to 15 percent; and became a company increasingly less productive, as I understand it, over that period of time. And now, billions of pounds have gone into that particularly industry.

You may not have known that the Brit sh Government was, at the beginning of the decade, helping almost a dozen companies, and when I checked a year ago, prior to my Chrysler testimony, they were up to 49 companies.

Those companies are now in such shape that Mrs. Thatcher is having great difficulty selling these companies which tells you something.

Now, one of the lessons that I am drawing from our Japanese experience—and the Senator from Michigan, who of course, was not thrilled with my comments, said to me, didn't a person with my experience understand that Japan helps its industries? And how could I take the position I had taken, and not be for aid here?

I said to the Senator from Michigan: "I have spent a lot of time looking at Japan, and I had a somewhat different understanding of what they were doing." They seemed to be putting their money into the industries of the future, not into the industries that were having competitive problems.

And what concerns me, Mr. Richmond, is that we are now at a point in this country where we can no longer do everything. And the dollar that is put into a RFC or into other such situations is a dollar that is not available to put in another situation.

Representative RICHMOND. But, Mr. Peterson, can you just tell me where—we know that Japan, for example, has 16 modern steel mills. We only have one.

Now, where is United States Steel Corp. going to get the necessary $2 billion or $3 billion per mill—and Bethlehem Steel, and all the rest—in order to modernize?

Just answer me that one question.

Mr. PETERSON. What I think would happen——

Representative RICHMOND. Or do you want them to go out of business?

Mr. PETERSON. No. I don't.

Representative RICHMOND. If you don't want them to go out of business, we have to figure out how we can get them some money.

Mr. PETERSON. I don't want anybody to go out of business.

But frankly, Mr. Richmond, one of my favorite words is a word called "iatrogenic." There is an iatrogenic disease in medicine, that the doctors rarely talk about. It comes from the Latin and the Greek "genic" and "iatro," meaning "doctor." This is the whole category of diseases that are caused by the doctor, the medical treatment.

And my study of a lot of these efforts—however well motivated to "support" an industry—is that they end up being iatrogenic. That is, they do not end up, in the final analysis, doing a great deal.

But my more basic point is that the $100 billion we put into an RFC to help "needy industries" is $100 billion that is not available to be put in other industries. And we are at the point in our lives, Mr. Richmond, in my judgment now—and I know you probably don't agree with me—where very painful trade-offs are necessary.

So I, I guess, am espousing a more Republican view on this subject.

I would rather that we give a lot more savings and investment incentives, and put a lot more money available to be invested. And then, let the people who have to invest that money decide where the best places are to put it.

So, generally speaking, interventionist solutions, planning solutions are not really compatible with my basic——

Representative RICHMOND. So, what you're saying is: "Change the investment climate, in order to generate more savings and investment"?

Mr. PETERSON. I would like a lot more money available, and make it a lot more attractive for people to save and invest. And then I would let the businesses of this country and the capital markers of this country decide where to put that money.

And a lot of that money would find itself in the steel industry.

Representative RICHMOND. Mr. Peterson, I wonder whether, at your convenience, you would give us a critique of this budget? I'm very interested in hearing some of your comments on it. It is called the "share the burden" budget,[1] and we just made it public last week. But I would really like to see what you think about it.

Mr. PETERSON. I will take advantage of that.

Representative RICHMOND. Thank you.

And thank you for giving me extra time, Mr. Chairman.

Representative REUSS. Thank you.

Now, Mr. Peterson, among other things, you raised the question of conflicting signals and the need for consensus.

As you know, the current principal actors in these conflicting signals are President Reagan, on the one hand, and the House Democrats on the other. The House is where the opposition party still is technically in control.

And what the House Democrats are saying is that, on the tax reduction side, they believe that personal tax cuts ought to take a back seat to a more investment-oriented program. This means that a tax cut ought to be lesser in amount, so that there isn't such a huge deficit; so that the Treasury doesn't have to go in and grab even more than the quarter of the total that it grabs now.

And second, that whatever is the total tax cut, that a larger percentage of it, under the Reagan program, ought to be investment-oriented. That is what the argument is all about. And it is President Reagan who is intransigent, who refuses to come down off his high horse, whose associates threaten vetos.

Isn't the way to consensus, then—and here, I call upon you for the moment of absolute truth—for President Reagan to stop his "I'm-going-to-veto-it" approach? Shouldn't he sit down with the Democrats, to see whether a tax cut can be crafted which is smaller in total amount, and thus less deficit-causing, and within that amount more dedicated to investment?

Mr. PETERSON. Mr. Chairman, I can't possibly speculate on what the President would or would not do to an investment-oriented program.

But let me offer a possible hypothesis for your consideration.

I truly believe that he deserves—I've said, on another occasion, that those of us in the Nixon administration were never bothered by excessive hyperbole, and some of our historic firsts that you will recall were nothing more than MEGO's.

But I think this President deserves enormous credit for an historic first, in the sense that now the American people do have this understanding of our economic problem, inflation being really the enemy No. 1. That we need to cut back spending. All they have to do is look on the streets and in the homes to understand our competitive problem.

But I ask you, is it possible, that in the summer of 1980 and in that particular climate—it is very reasonable—that it would have been

[1] See insert on p. 118.

hard to predict the enormity and the success of the very momentum that his brilliant political achievements have made possible?

And that perhaps the people, in a curious sense, are at this point ready to go much further along certain lines than they would have been last summer?

For example, I happen to be a fan of Phil Donahue's, and occasionally I watch that program. And they had on that program, not too long ago, Adam Smith, who has done this new book called "Paper Money." And Phil Donahue—and I don't mean this as a sexist comment—was asking these women, most of whom, I assume, were not working at the time, what they understood America's economic problem to be.

And to my astonishment, they gave—most of them gave an economic lesson that would have been worthy of any Joint Economic hearing. They just simply said we're not saving enough in this country, and we're not investing enough.

I think what may have happened, Mr. Chairman, is that politically something is possible today that may not have been possible last summer, or even a few months ago.

I saw Senator Roth last night, at a dinner. It is hard for me to believe that Senator Roth, for example, wouldn't be interested in reducing the rate on unearned income. I mean, it is at least hard for me to believe that.

And I'm just speculating along with you. I don't know.

Representative REUSS. Well, it isn't just Senator Roth who's interested in doing that. It is another gentleman whose name begins with R, called Rostenkowski, who wants to do that, but is being rebuffed by the White House and all of its adjuncts.

So it takes two to tango. And it looks to me as if the Democrats aren't finding a partner in the kind of compromise you were talking about.

You want the top bracket lowered; so do we. You want more direct incentives toward savings, rather than toward consuming or speculating; so do we. You want more assurance that that which is saved will actually get into the incalculably valuable new plants and equipment that Japan has; so do we.

But an undifferentiated $148 billion a year tax cut in the individual income tax certainly affects those goals only remotely. And it raises hell with the budget deficit. And will cause the Treasury, if enacted, to go in and borrow even more, at even higher interest rates, and ruin capital investment.

Do you disagree with that?

Mr. PETERSON. Well, Mr. Chairman, on the Chrysler situation, I guess I was among those who suggested that if you are destined to do it anyway, why don't you set up a loan guarantee board or something that will at least put some discipline and viability standards into the process.

And I thought a long time before making that particular suggestion.

I have thought a little bit about my suggestion for your consideration, because I think it is irresponsible for a Secretary of Commerce—who isn't taken too seriously when he's active, let alone when he's inactive—to propose a tax program that really requires the expertise of the Secretary of the Treasury and the Chairman of the Federal Reserve, who would have a great deal more knowledge than I do.

And in the interest of trying to move this ahead, I thought a little bit about the suggestion that perhaps this committee, to stop inflation—which, as I understand it, is a bipartisan effort—with Arthur Burns, for whom I have enormous admiration, and ex-Secretary of the Treasury Fowler, as well—and I think there is an assortment of Republicans and Democrats there. That perhaps what is needed is not for me to shoot from the hip, here, on a piecemeal effort.

But, perhaps, to see if there is some kind of a comprehensive program that could be worked out on a kind of a bipartisan basis, to move in the direction of more investment and savings-oriented programs. Because, really, what you do about depreciation is obviously part of this total package, and I think it would be irresponsible to just keep taking little twigs from this tree and throwing them onto the fire.

But I think, in general, there are enough people out there who want to see us save and invest more. And in my heart of hearts, I can't believe that most Republicans don't want to save and invest more.

That there ought to be a way that you political figures—I have said I'm not a politician—could get more consensus around that issue.

So maybe that is one avenue of doing it. Maybe there is another avenue. I don't know.

Representative REUSS. Let me ask you for your shorter term views on the economy. Or rather, I will put it in terms of my own perceptions.

For the 6 months or 9 months ahead of us—the rest of this year—I am beginning to feel some perturbations.

I am beginning to feel that for a variety of reasons: For the fact that inflation and the payroll tax increase have lessened people's real spending power; for the fact that our exports are not quite as abundant as they were for a variety of reasons; for the fact that capital investment, always inadequate, is showing signs of being even more inadequate; and the fact that government spending, quite properly, is on its way down, as a proportion of the total spending.

For all those reasons, I see misery ahead in the short term. I see, if we pursue our present course, half a million men and women, this year, let out of jobs because we continue to mismanage our economy.

I'll now put my two questions:

First, what do you see in the short term, for the rest of 1981?

Second, if you shared, to any extent, my feeling that 1981 is not going to be all that glorious, shouldn't the Congress and the administration try to get its act together right now, so that the modest stimulus—and I emphasize "modest"—attained by a tax cut—and we all agree that there should be a tax cut of sorts—can be brought onstream early, where it may mitigate anticipated problems and save us from throwing out into the street 500,000 men and women?

Mr. PETERSON. Mr. Chairman, the advertising question that I raised—that if eventually, why not now—was one I gave some thought to.

And I spend my life on Wall Street, and I think I should share with you—while I've only been there 8 years, I know I've been there long enough to have some perspective.

I have never seen a time, in my 8 years, where there are such radically different prognostications of what's going to happen.

We have some in the administration, and some out of the administration, projecting interest rates I believe, at yearend, in the range of 10 percent. We have other people who, incidentally, do put their money where their mouths are; that is, they invest in various types of interest-sensitive securities; and they are persuaded that interest rates at yearend will be 21 percent, or even more.

That is what you would call a minor difference in views.

Now, why do those people believe—and you undoubtedly heard from some of them—why do they believe, those that do, that interest rates will be very high?

Well, one of the reasons, Mr. Chairman, I think they believe it is that they are quite concerned, as they tell me, that our budget deficits will be considerably larger than we may be thinking they are. Which will come about both from the revenues falling off and the spending cuts not being what they would hope.

And from the view of longer term expectations, that if we are not really willing to get at some of these problems now, the long-term inflationary expectations will continue to be high; quite apart from the effects on unemployment.

One of the areas of this country that I'm most concerned about, unless we effect to bring interest rates down, are the thrift institutions of this country in which, as I'm sure you know—we have, what, something like $900 billion of equity, or something of that sort. They are losing that equity at a very alarming rate. They are caught in this problem of interest rates being too high.

In my judgment, among the people on Wall Street that talk to me, among the economic advisers that we listen to, I would have to tell you that a litmus test of our long-term interest on the budget side is the very large programs that I mentioned to you, the transfer payment programs; and I've had many people say to me what the Congress does about those programs will say a great deal to capital markets as to whether we are really willing to tackle some of the difficult political issues that we face.

And that was one reason why I, as a Republican and a strong supporter of the administration, nonetheless think that issue should be raised.

Representative REUSS. Of course, it is asking a little much of Congress that it immolate itself on this courageous reexamination of the indexing of social security, when the administration would veto it. The administration specifically rejected it.

In other words, doesn't the initiative there have to come from the administration? I can guarantee enough Democratic votes.

Mr. PETERSON. Mr. Chairman, I've heard our President, whom I admire greatly, say I think—or his top aides say that he doesn't make predictions about what he is going to veto. And therefore I would encourage you to take the risk, and you may find out that it will turn out to be a benefit if the Democratic side of the House were to take on those programs.

Second, the other signal——

Representative REUSS. Do you guarantee that if we do it and that if then Mr. Reagan vetoes it, every Republican won't be running against us as the betrayers of the old folks who tried to do them in? With that assurance, I am ready to go.

Mr. PETERSON. Mr. Reuss, about 30 years ago I once was asked a similar question by a client who asked me if I would stake my reputation on a prediction I'd made; and I said yes, sir, I would. And he said, well, it will have to be something more substantial than that. [Laughter.]

I don't think that my guarantee would be worth much on that issue. But as a citizen of this country who has spent a lot of time studying these trends, I would encourage the Democrats to do that.

The other signal that I think Wall Street is looking for is a signal that we are really serious about savings and investment; and I think if you were to attack the huge entitlement programs that we have mentioned and really do something about them, and do something on the savings and investment side, that would do a great deal to send signals to the capital markets that we really are going to do something about inflation, long term.

Representative REUSS. Getting back to the eventually versus why not now point; namely, since there is tax reduction in the wind, and since there is some feeling on the parts of some that the rest of 1981 may be very slow and attended by increasing unemployment, wouldn't it be a particularly good idea to try to reach consensus on a passable tax cut that both parties, Democrats and Republicans, agree on, and get that in place?

Because, you know you are going to need something like that anyway. Everybody accepts that. Certainly the administration. So why not put into place a tax cut which could either then grow into something bigger, or stay where it is for a while, if that is what is needed to get the budget under control.

Mr. PETERSON. Particularly if you would include in what you said action on the entitlement programs, because you see, in addition to the symbolic signal to the markets that our country is really willing to take on the expenditures that, as you know, have tripled in the last 10 years and have been going up 65 percent faster, roughly, than real income, and I'm talking about a lot of these programs, the other thing that a larger budget cut would do is reduce the concerns about the deficit and Government borrowing being even larger.

So I would like to see you come up with a program soon in some bipartisan context, that would simultaneously take on the transfer payments issue and come up with a tax program oriented more toward the investment tax side. And I agree totally that the sooner, the better.

Representative REUSS. Well, I'm glad to hear you say that. And knowing your courage, I don't feel baffled at all about asking you to tell that to the people on your side of the aisle, because the Democrats in the House favor just that kind of a tax approach we are talking about. And some of us, like Mr. Richmond and myself, feel that the entitlements should be part of the package.

Well, you have been awfully helpful to us, and we are going to study your charts and other material very carefully. And we will certainly seriously consider the advice you gave us about some possible additional witnesses. So thank you very much for being with us.

The committee stands adjourned.

[Whereupon, at 11:25 a.m., the committee adjourned, subject to the call of the Chair.]

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